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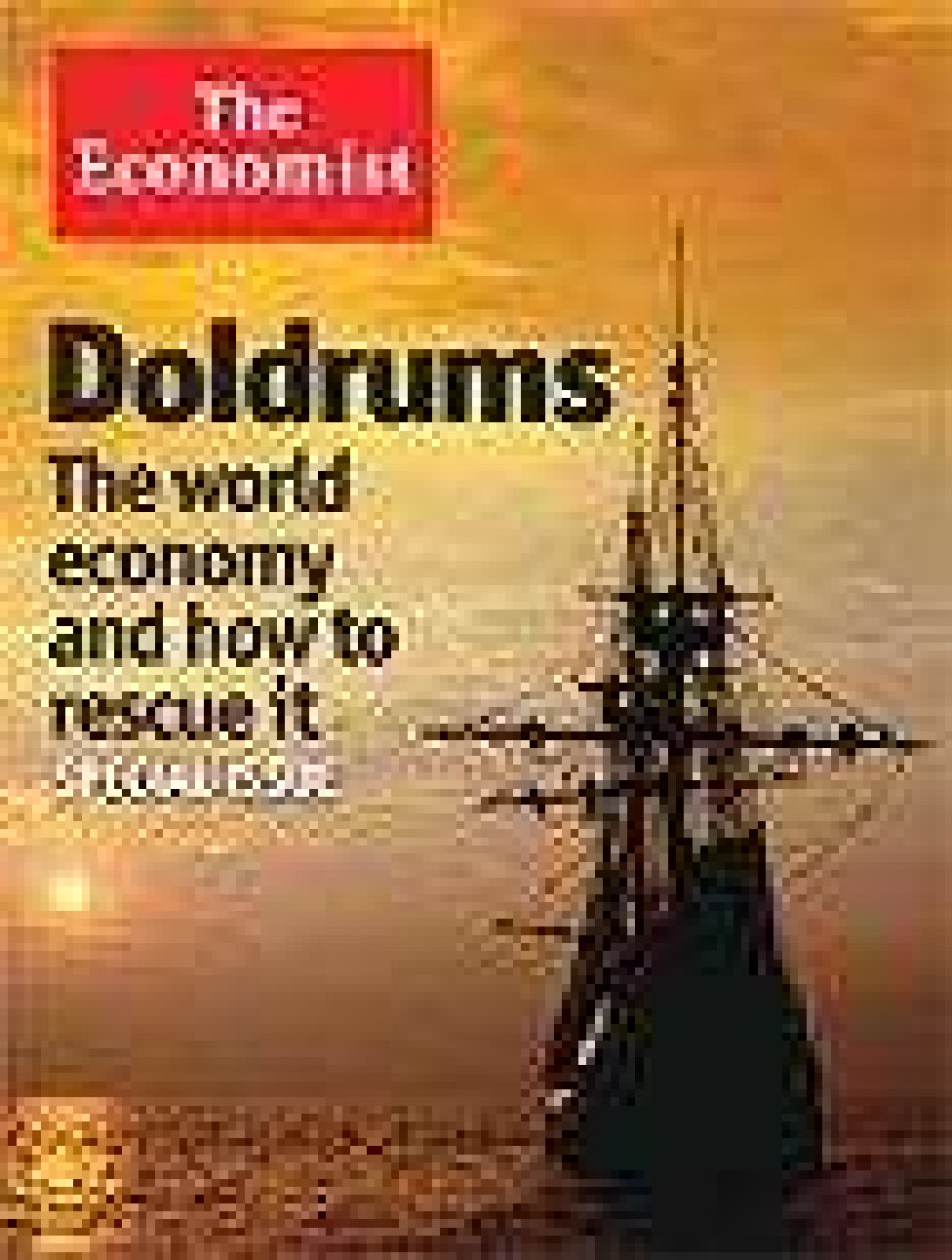
Doldrums

The world economy and how to rescue it



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Politics this week

Sep 26th 2002
From The Economist print edition

Threatening pre-emption

The Bush administration published a new **National Security Strategy**, pledging to work with allies but also emphasising that "to forestall or prevent...hostile acts...the United States will, if necessary, act pre-emptively." Al Gore, the former vice-president, attacked both the doctrine of pre-emption and the administration's apparent determination to attack Iraq, saying it was damaging both the effort to fight terrorism and America's alliances.

See article: George Bush's new national security strategy

Gray Davis, the governor of California, signed a bill allowing scientists in his state to use embryonic **stem cells** for research, defying federal restrictions on the practice.

See article: California rebels about stem-cell research

According to the Census Bureau, the proportion of Americans in poverty (living on less than $18,104 a year for a family of four) rose last year by 0.4 percentage points to 11.7%, the first rise for eight years.

Schröder scrapes in

Germany's chancellor, Gerhard Schröder, and his ruling coalition of Social Democrats and Greens narrowly won re-election, beating the conservative Christian Democrats and their Bavarian sister party, the Christian Social Union, led by Edmund Stoiber, by a handful of seats. The Greens tipped the balance by winning nearly 9% of the vote, a point ahead of the Free Democrats, Germany's liberals, who were thought more likely to team up with the conservatives.

See article: Schröder scrapes home

Donald Rumsfeld, America's defence secretary, said that relations between the United States and **Germany** had been "poisoned" by the vehemence of Mr Schröder's refusal to let Germany join an attack against Iraq, even under a UN mandate, and by the alleged comparison of George Bush with Hitler by Germany's justice minister.

Russia appeared to soften its opposition to the drafting of a new UN resolution on Iraq after its foreign minister, Igor Ivanov, said that his government was prepared to discuss the issue. America said that Iraq had helped al-Qaeda to develop chemical weapons.

Slovakia's ruling centre-right coalition combined to defeat the country's former strongman, Vladimir Meciar, who nonetheless topped the poll in a general election with 20%. The country now looks set to join NATO and the EU.

See article: Slovakia votes sensibly

In Spain's **Basque** region a civil guard was killed by a booby-trap planted by members of the separatist terror group, ETA. A day earlier two ETA members blew themselves up when explosives in their car went off accidentally.

See article: The complications of banning the Basque terrorists' mouthpiece

Fighting violence

Over 3,000 soldiers were sent to the western state of Gujarat, in **India**, in an effort to prevent widespread violence after suspected Islamic militants killed over 30 people in a Hindu temple. In February, inter-communal violence in the state left thousands of Muslims dead after an attack on a train carrying Hindus.

See article: Gujarat, India's tinderbox

Nineteen people, including five security personnel and nine suspected Islamic militants, died in violence after the second round of voting for the state assembly in Indian-administered **Kashmir**. Only 11% of voters turned out in Srinagar, the Muslim-majority city at the centre of the insurgency against Indian rule.

Unidentified gunmen shot dead seven Pakistani employees of a Christian charity in Karachi in **Pakistan**. Attacks on Christians elsewhere in the country have killed more than 30 people in the past year.

A government offensive in **Nepal** against Maoist rebels saw more than 150 insurgents killed. The offensive came in response to recent rebel attacks on army barracks and police stations in which around 100 security personnel died.

Concerned that the transitional administration of Hamid Karzai could not cope, **Afghanistan's** minister for refugees asked Britain and other European countries not to force asylum-seekers back to the war-ravaged country.

An **Indonesian** human-rights organisation concluded that army special forces were probably behind the killing of two Americans and an Indonesian in Papua province in August. The army had blamed separatist rebels for the attack.

America said it will soon despatch an envoy to **North Korea**. The reclusive state has embarked on a diplomatic charm offensive.

Hurricane force

AP

After battering Cuba, hurricane Isidore hit the Yucatan peninsula in **Mexico**, killing at least three people and forcing tens of thousands out of their homes.

Intensifying its war against the country's rebels, the government of **Colombia** established “security zones”, giving the military sweeping powers to re-establish the authority of the state. The measure coincides with a visit to Washington of the country's new president, Alvaro Uribe, who is seeking more help.

See article: Drugs and politics in Colombia

Argentina's government said “the world won't end” without an IMF aid deal. Repayments, however, could. Roberto Lavagna, the economy minister, said an IMF package was the only way to avoid defaulting on repayments to multilateral lenders.

See article: A time for caution

Arafat's diminishing base

Reuters

After last week's suicide bomb in Tel Aviv, the Israeli army demolished all but one of the buildings in **Yasser Arafat's** Ramallah headquarters, besieging him and 200 others in the remaining wing. George Bush called

Israel's action “unhelpful” and America abstained as the UN Security Council passed a resolution calling on Israel to stop its military operation in Ramallah and to withdraw expeditiously from the Palestinian cities it occupies.

See article: Arafat hangs on

Fighting continued in **Côte d'Ivoire** after an attempted coup. American troops flew in to help the French garrison protect foreigners, including 20,000 French citizens and 170 American children trapped in a mission school in Bouaké, a rebel-held town.

See article: A failed coup in Côte d'Ivoire

Talks aimed at securing a ceasefire in **Burundi** failed after the main rebel group could not even agree on terms under which its representatives might meet with the government.

See article: Peace talks fail in Burundi

The late Nigerian dictator **Sani Abacha's** son, Mohammed, was released from jail, where he had been detained since 1999 on corruption charges. He was freed reportedly on condition that he return most of the $1.5 billion his father is estimated to have stolen.

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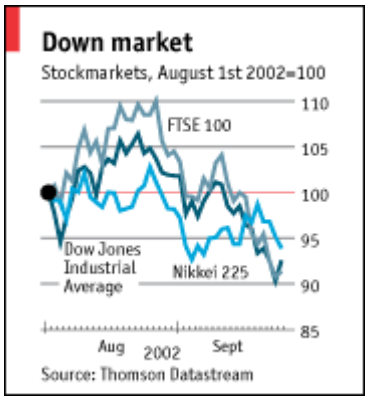
Business this week

Sep 26th 2002
From The Economist print edition

All fall down



More bad times for the world's **stockmarkets**. America's Dow Jones and Nasdaq continued down as worries about the economy and rising oil prices took hold. Before rallying on September 25th, Britain's FTSE 100 hit a six-year low. Germany's Xetra Dax Index fell after Gerhard Schröder's narrow victory in weekend elections.

See article: Europe's tumbling stockmarkets

The Federal Reserve left interest rates unchanged but voiced growing concerns over the slow rate of **America's economic recovery**. Alan Greenspan, the Fed's chairman, arrived in Britain to receive an honorary knighthood for his efforts at maintaining economic stability.

See article: The world economy in the doldrums

The IMF added to the gloom. Its *World Economic Outlook* suggested that the **world economy** is recovering only slowly. Estimates for America's growth this year were cut to 2.2% and slashed for 2003. The Fund now expects the world economy to grow by just 3.7% in 2003, down from 4%.

See article: The IMF

The EU's "**growth and stability pact**", the supposed rock on which the euro's credibility is founded, suffered tremors. As the euro area's big economies (France, Germany and Italy) together with Portugal looked likely to breach the pact's upper limit for fiscal deficits of 3% of GDP, the European Commission decided to extend by two years (to 2006) the deadline for balanced budgets. The Union's smaller countries complained: they had made stringent efforts to meet the deadline.

The **Bank of Japan** added to the amazement caused by its decision to buy shares from banks with an admission that it was "an independent decision based on a serious concern about the state of the financial system" and was intended as a "catalyst" to spur action by government and regulators on the banks' mountainous bad-loan problem. It also admitted that the new policy was "a big gamble".

See article: The Bank of Japan comes clean

Fischer overboard

Citing "differences of opinion", Leonhard Fischer abruptly quit as chief executive of the loss-making corporate- and investment-banking arm of Germany's **Dresdner Bank**. Although Mr Fischer has sacked his fellow investment bankers by the hundreds. Dresdner still has to deal with its high corporate-banking costs.

Goldman Sachs reported profits for the third quarter of $522m, up by 12% on a year ago, as money from trading offset a decline in income from mergers and acquisitions at the American investment bank. Trading activities suffered at **Lehman Brothers**, Goldman's poor relation, propelling its profits down by 37% in the third quarter, to $194m.

See article: Investment banks

The top brass at **AMP** paid the price for the company's poor performance and plunging share price. The chief executive of the Australian insurance firm will depart at once, the chairman in six months' time.

Citigroup's investment bank, **Salomon Smith Barney**, was fined $5m by American regulators for issuing misleadingly bullish research about Winstar Communications, a now bankrupt telecoms company that was also a client of the bank. Regulators also filed a complaint against Jack Grubman, once Salomon's star telecoms analyst, and his former assistant, the authors of the research in question.

Universal strategy

Vivendi Universal set out long-awaited plans to reduce its prodigious debt pile. It plans to sell assets worth up to *euro*12 billion ($11.8 billion), and confirmed that its publishing businesses would go. But the French media giant gave little indication of the future of its stakes in Vivendi Environnement, a utility, or Cegetel, a French telecoms firm; rumours abounded that both would be sold. It also announced a board shake-up; six members resigned.

See article: Vivendi's global media dream lives on

Alcatel, a struggling French telecoms-equipment maker, raised some much needed cash by selling a stake of just over 6% of Thales, a French defence company. It will raise some *euro*340m ($333m) while retaining some 10% of Thales. Days before, Alcatel had predicted a bad year and announced 10,000 jobs cuts, some 14% of its total employees, before the end of 2003.

Bad copy?

Xerox faced a criminal investigation arising from suspicions that it had inflated its profits. In April, the heavily indebted copier company was fined $10m after a probe of its accounting practices by America's Securities and Exchange Commission revealed widespread abuse. Xerox says it has cleaned up its act.

America's energy regulators strongly hinted that they blame energy companies for **California's energy crisis** of 2000-2001. A ruling that subsidiaries of El Paso, a gas company, had restricted supply during the crisis suggests that it and others will shoulder the blame—and be made to cough up—for the power problems.

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The world economy

How to rescue it

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The world economy is in the doldrums. Both monetary and fiscal policy need to be put to work

CENTRAL bankers are popularly portrayed like ships' captains carefully steering their economies. In reality, central bankers have more in common with the early navigators: they often don't know where they are, let alone where they are heading; their maps and compasses are unreliable and their steering is wonky. Worst of all, their recent policy dilemmas are the equivalent of not knowing whether the earth is round or flat. Today's central bankers learnt their trade in a world where the main danger was inflation. But in recent years, the biggest hazards have instead been asset-price bubbles and now, perhaps, deflation. As shares slump and economies wobble, the world's top economic policymakers meeting this weekend for the annual meetings of the IMF and the World Bank (see article) will be asking whether the navigators can now rescue the world from its current doldrums.

Most American economists reckon that their economy is under way again after being halted last year: they typically expect growth to return to trend or above during the next 12 months. They still do not grasp that this recession was quite different from all previous post-war cycles. It followed the bursting of the biggest financial bubble in American history. Share prices have since seen their biggest fall since the Great Depression. During the bubble years, decisions across the whole economy—about investment, borrowing and saving—were distorted by unrealistic expectations about future profits and share prices, and a belief that the business cycle was dead. The latter was particularly foolish: our survey in this issue argues that not only is the cycle likely to turn bumpier in future, but America's current downturn is far from over. The economy is unlikely to return to vigorous and sustained growth until the excesses created by the bubble have gone. Consumers continue to borrow as if little has changed, encouraged by low interest rates and rising house prices. But debts cannot rise faster than incomes for ever; eventually households will need to save more and spend less, which implies several years of slow growth or even a double-dip recession.

The other big economies are in no better shape. Japan's grew in the second quarter, but it remains fragile and deflation continues unabated. The Bank of Japan's desperate plan to buy shares from banks (see article) is unlikely to help, especially as there is plainly no coherence in the plan nor any clear policy response from the finance ministry either. In the euro area domestic demand is virtually flat; most of its pathetic growth over the past year has come from exports. Share prices, which have fallen by even more from their peak than on Wall Street, are depressing consumer and business confidence in Europe by more than in the past. Germany's GDP may now be shrinking again. Add to this fragile global mix the risk that military action against Iraq will push up oil prices temporarily and further reduce share prices, and the outlook looks bleak.

America's economy is unlikely to return to vigorous and sustained growth until the excesses created by the bubble have gone

So why did America's Federal Reserve not cut interest rates this week? It faces a dilemma. On the one hand, America's economy needs a period of below-trend growth to eliminate its financial excesses. This argues against a rate cut, which would only encourage consumers to borrow even more, exacerbating America's financial imbalances and simply postponing the day of reckoning. On the other hand, a weak economy at a time when inflation is already low (1% as measured by the GDP deflator), could lead to deflation. This argues for aggressive monetary easing.

One way out of this dilemma would be a sharp fall in the dollar, which would allow America to unwind its

imbalances without a recession. A cheaper dollar would boost exports to offset weaker domestic spending and also prevent deflation by lifting import prices. The snag is that this would export deflation to Japan and Europe, and neither appears to be able or willing to bring about an offsetting economic stimulus. That appearance, though, is deceptive.

Turn on the engines

Even if the big economies do not actually slip back into recession, global growth is likely to remain well below trend, which will cause inflation to fall further. There is therefore a risk that by the end of next year the big three economies, America, Germany and Japan, will all have falling prices. History suggests that central banks should do everything they can to avoid deflation, which is far more harmful than inflation, especially when economies are awash with debt. But today's policymakers, trained to fight inflation, are ill prepared. Japanese interest rates are already at zero and the Fed does not have much ammunition left, with rates at a 40-year low of 1.75%. The European Central Bank (ECB) has the most room to cut rates (currently 3.25%), but its telescope is so keenly searching for any hint of inflation on the horizon that it is oblivious to deflationary icebergs floating by. The ECB's inflation target of “less than 2%” is also too low; it provides an inadequate cushion against the risk of deflation in the event of a serious slump in demand.

The current monetary-policy risks are lop-sided. If a cut in rates turns out to have been unnecessary, it can easily be reversed; and with ample spare capacity there is little risk of inflation soaring. On the other hand, once deflation sets in, nominal interest rates cannot normally fall below zero, so there is no way to deliver the negative real interest rates that may be needed to pull an economy out of recession. The lesson from Japan is that the Fed and the ECB should cut interest rates soon. Another lesson, though, is that as rates approach zero and monetary policy starts to feel like “pushing on a string”, as Keynes argued, fiscal policy needs to play a bigger role.

Instead there is currently much debate in America, Japan and the euro area about the need to cut budget deficits to prevent the build-up of unsustainable public debts. That would be folly, grand scale. At the very least, built-in fiscal stabilisers (the automatic fall in tax revenues and rise in jobless benefits as economies weaken) should be allowed to operate fully. Europe's fiscal stability pact, in particular, foolishly prevents this. If a government's deficit breaches 3% of GDP it can be automatically forced to tighten policy even if the economy is in recession. That now seems likely to happen to Germany. This week the European Commission proposed to relax a deadline the pact had set for budgets to balance; this would be welcome but is nowhere near enough. The euro members need to loosen their fiscal straitjacket immediately and rewrite the stability pact to take account of the cycle. Some argue that to rewrite the pact now would hurt the euro's credibility. But it is far worse to stick to a lousy policy than to admit it is wrong and change it. Ask Argentina.

Even if the big economies do not actually slip back into recession, global growth is likely to remain well below trend, which will cause inflation to fall further

Admittedly, discretionary fiscal fine-tuning has a poor record. It is hard to get the timing right and in normal circumstances it seems less effective in boosting demand than was once thought. Deflation, though, is highly abnormal. If monetary policy becomes impotent, a budgetary stimulus is the only weapon left. Contrary to popular opinion, fiscal stimulus has worked in Japan when it has been tried. But Japan's true stimulus has been much more modest than the increase in its budget deficit would suggest. Most of the increase in borrowing has been due to a fall in tax revenues as GDP has shrunk. It is not too late for Japan to fight deflation by pursuing a proper fiscal reflation, which could be financed by the Bank of Japan buying government bonds. If the Bank refuses to do that then the finance ministry should do its own reflation by intervening in the currency markets to drive down the yen.

All around the world, extra measures are needed. Only two years ago, Alan Greenspan, the Fed's saintly navigator, believed America's economy was heading into a new world of faster growth and higher profits. Instead it looks horribly like the old world before 1939 when financial bubbles and investment-led booms always eventually ended in bust. Somehow or other, America needs to rid itself of its financial excesses, and it is in that sense that America's “recession” is far from over. If the world economy is to get moving again, it is time not only for the Fed to cut interest rates but also for Europe and Japan to turn on their engines. Doldrums are dangerous.

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American foreign policy

Pre-empting threats, threatening pre-emption

Sep 26th 2002
From The Economist print edition

Only Saddam Hussein, and any would-be emulators, need fear George Bush's foreign policy

AP

MUCH of the time, foreign policy is made by hints, bribery, threats and, in this televisual age, soundbites. This week it was made in a pair of substantial documents—America's new "National Security Strategy", outlining George Bush's foreign-policy thinking, and the British government's "assessment" of Iraq's weapons of mass destruction. The first was intended to reassure, the other to scare. The truly scary thing is that much of the reaction to these documents—in soundbites, naturally—has got them the wrong way round.

Mr Bush's "strategy", which is the sort of thing every administration gets round to assembling, contained nothing seriously new (see article). What caught the attention, though, was one element that had been mentioned before but not fully fleshed out: the notion that, if America saw that a country or organisation was developing nuclear, chemical or biological weapons for use against it, then it would be willing to take pre-emptive action to deal with that threat. In other words, it would not wait until thousands or millions of people had been killed. Such action need not only mean war, the report stressed, and would not necessarily be done by America alone. But if a unilateral military strike were absolutely necessary, then Mr Bush said he was willing to order one.

The question is: should you be scared by that, or reassured? First of all, some distracting arguments need to be cleared away. This does not, as some say, set a "precedent" for future invasions by any Russia, China or, indeed, Iraq. Despite the fine words of the United Nations Charter deploring the use of force, dozens of its signatories have used "pre-emptive" attacks during the past half-century: the Soviet Union on many occasions, Israel, Iraq, many African countries, India, Pakistan and the United States itself (in Grenada, for example), among others. And how good it would have been for the world, most people still think, if the democracies had pre-empted Hitler back in the mid-1930s. Second, it does not entail America giving itself new "rights" or flouting existing sources of "legitimacy": all Mr Bush has said is that, *in extremis*, he will act. So would many other countries, in their own extremity.

First and foremost, this is reassuring to Americans: if someone is building a suitcase nuclear bomb to be exploded in Chicago, the president will not wait for years of debate and piles of reports from international study-groups before doing something to stop it. Yet it should also reassure other people. They should be reassured by the promise that such a move is very much a last resort. But they should also be reassured by America's willingness to threaten it. For the point of the threat is old-fashioned deterrence: that by declaring your willingness to act, you will make it less likely that you will ever need to act. Such deterrence, in so far as it works, will help protect others too—especially as America, both in its general values and explicitly in this document, stands for freedom and democracy, not imperial conquest or dictatorship.

Saddam Hussein: a worked example

In the end, the basic issue is whether you trust America to act more-or-less wisely, or whether you think it (or Mr Bush personally) is in fact a Wild West cowboy. Given the careful, determined response Mr Bush gave to the terrorist attacks on September 11th, and given the fact that for all the words about "regime change" he has done nothing precipitate against Iraq, it is hard to find any evidence of cowboy tendencies, at least on his part. It ought also to be reassuring that his new security strategy is packed to

the brim with idealistic language about peace and prosperity for all, and full of declarations of intent to work with allies, reinforce non-proliferation treaties, operate through multilateral organisations and so on.

But should you believe such words? Scepticism is always in order when a government speaks, especially when strategy documents thud into the world's awkward realities. Iraq does, though, offer a case-study in how things might work. For it is hard to imagine a better current example of when to consider pre-emptive action as an alternative to containment: a murderous dictator and declared enemy of America who has been building stockpiles of chemical and biological weapons for 20 years, and is trying to develop nuclear weapons too.

However, far from blundering unilaterally into an invasion on a presidential whim, Mr Bush has placed the United Nations at the heart of his strategy against Saddam Hussein. His closest ally, Britain, this week laid out in painstaking detail the evidence of Mr Hussein's weapons programmes, his deceit, his evasion of weapons inspections and his use of such weapons in the past. The dossier (see article) contained only a few new facts but much that should be scary to those unfamiliar with Mr Hussein's past record. Now, Britain and America will try to persuade the Security Council to pass a new resolution threatening force unless Mr Hussein fulfils his past promises to disarm, which over the past 11 years have been the subject of 16 UN resolutions. The threat of invasion is being used as a last-but-one resort; the threat of a unilateral invasion is only a last resort. Mr Hussein, it is to be hoped, is now scared. On this evidence, nobody else needs to be.

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British politics

The two Tonys

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Is that world leader the same man as the British prime minister?

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THERE'S something rather heroic about Tony Blair at the moment. Heroic and wrong, some would say; heroic and right, this newspaper would contend; but nobody would deny that it takes courage to face down deep scepticism in your party, to see your natural allies in the press desert you and to watch your government's poll ratings slide—all for a policy which is unlikely to make a halfpenny-worth of difference to your performance in the next election.

The reason why Mr Blair cuts such an impressive figure these days is that he has total confidence in his moral and political instincts. He doesn't need focus groups or polls to tell him that his compass is true. The big tent has been packed up and put away, consensus-building is off the agenda and the Third Way is forgotten. The only way is Tony's way, and those who don't like it can lump it.

Yet however things go in Iraq, come the next election Mr Blair will be judged not on foreign policy, but, as he has asked to be, on whether or not people believe that he is delivering the improvements he has promised in key public services. And on this issue, Mr Blair cuts a very different figure. The single-minded courage with which he has pursued his aims abroad serves only to highlight the muddle-headedness and timidity which characterise his record at home. The results of the government's attempts to improve things (see article) are as unimpressive as Mr Blair's performance.

The best hope for Britain is that Mr Blair's Iraq policy is a success, for he might then turn to domestic affairs with new vigour

Take exams, for instance, a particularly hot topic this week. Without really thinking, Mr Blair has subscribed to the idea that headlong expansion of higher education is a good thing. He talks of “nobody being left behind” and the opportunity for everyone to fulfil their potential. The practical application of these pleasant sentiments is the government's determination to send 50% of the population to university. But without better secondary education, the only way of ensuring that enough students scrape the necessary A-levels to get to university is the new, dumbed-down, exam system for 18-year-olds. Predictably, it has resulted in catastrophe, with examiners apparently manipulating some students' marks downwards to conceal the dumbing-down. Voters are left with the impression not just that the government has been cheating their children, but that it has been doing so incompetently. And, as the Tories learnt after Britain was spat out of the European exchange-rate mechanism ten years ago, there's nothing voters dislike so much as incompetence.

The National Health Service has escaped such spectacular disaster; but neither does it show any sign of improvement. The main flaw in the government's policy on health—and the other public services—is that it is spending without reforming. Although the NHS has seen its budget rise by a third since 1998, little has been done to encourage more competition to state-owned providers or to offer more choice to consumers. Power has been centralised, not devolved. Yet it is hard to find anybody who knows the NHS and seriously believes that an organisation employing a million people can be made to work. What's more, by pouring money into a fundamentally flawed system, the government is jeopardising its one real domestic achievement so far—not having messed up the economy.

The Falklands factor, again

Gordon Brown, the chancellor, does not see the need to dismantle the NHS or even decentralise power within it. Reform is best achieved through targets set by himself. So long as every doctor does what the Treasury tells her to, the system will work fine. Mr Blair has become uncomfortable with this belief in command and control—his proxy, the health secretary, Alan Milburn, has engaged in battle over the setting up of semi-independent “foundation” hospitals that Mr Milburn supports and Mr Brown opposes, for instance—but it's hard to tell, for Mr Blair rarely asserts himself domestically these days.

That has been especially true over the past few months, and not just because Mr Blair (rightly) thinks that current events abroad are of greater moment than those at home. It is also because Mr Blair, like any politician, has only a limited amount of political capital. When he is spending heavily on bringing doubters in line on Iraq, he has little to spare for the intractable business of public service reform.

That may change. The best hope for Britain is that Mr Blair's Iraq policy is a success, for he might then turn to domestic affairs with new vigour. That, after all, is what happened with Margaret Thatcher. Her most active period of reform came after she defeated aggressors abroad and doubters at home over the Falklands in 1982.

Mr Blair's performance over Iraq has shown how impressive a world leader he can be. It would be nice to have a British prime minister with that sort of energy and courage.

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Hong Kong

Subverting autocracy

Sep 26th 2002
From The Economist print edition

Plans for an anti-subversion law are not as bad as feared—but are still a big step in a very wrong direction

AP

"THE well water should not interfere with the river water," Deng Xiaoping once said, meaning that Hong Kong should not seek to meddle with China after it was handed back in 1997. Most of the concern had been the other way around: that China might damage Hong Kong's economic and political freedoms. Deng foresaw that a free-wheeling place like Hong Kong could hardly help but pose a challenge to China's political rigidities. Sadly, though, he drew the wrong conclusion. So the Chinese authorities have long pressed Hong Kong to introduce laws that would outlaw any attempt to "subvert"—for which, read challenge—its system.

At last, the attempt has succeeded: the administration of Tung Chee-hwa this week released its proposals for a new raft of laws which will make it harder for Hong Kong to act as a focus for dissent in China (see article). The proposals, it is true, could certainly have been worse. The offences they define—treason, secession, sedition and subversion—all require the commission of, or the incitement to commit, acts of violence against people, property or services. Merely demonstrating peacefully for regime change or the independence of Taiwan, or writing newspaper articles encouraging either objective, will not get you banged up, as it surely would in China proper.

Still, nestling among the plans are a few more alarming aspects. An organisation (such as the exercise cult Falun Gong, to take a far from hypothetical example) could under the new plans be banned automatically by Hong Kong if China decides that it is a threat to national security rather than just an "evil cult", or if it finds a way to define it as a "political party". The rules on disclosing official secrets are tightened. There is the suggestion that hacking into Internet sites could be construed as an act of violence. Inciting public disorder could become a crime.

Naturally, the Hong Kong government defends itself vigorously, explaining that its proposals are akin to those on the books in many other common-law countries. But there is something unpalatable about the attempt by the Hong Kong government's lawyers to dress up what they are doing in the language of western governance. The precedents they rely on are of democracies taking what are acknowledged to be extreme reserve powers to protect themselves from the small risk of an attempt at overthrow by small but violent groups of extremists. Such powers are tightly controlled by the fact that their users must answer to voters and to independent courts.

The case of Hong Kong's new laws is in each detail the reverse of that. The proposals Mr Tung's administration has come up with have been pressed on him by Beijing in order to protect a self-appointed regime from highly probable attempts, which would be supported by the great mass of Chinese people, to secure the democratic rights enjoyed almost everywhere else in Asia. Such actions, moreover, are subject to very little control: Mr Tung has recently been reinstalled for another five years, without even the formality of a vote by Hong Kong's Beijing-picked electoral college. And Hong Kong's courts, as has already been established, are subject to reversal by China's. An anti-subversion law is bad for Hong Kong and, in the end, is bad for China too.

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Yasser Arafat

Arafat under siege, again

Sep 26th 2002
From The Economist print edition

How not to change the Palestinian regime

Getty

Get article background

IF THERE were a Yasser Arafat preservation society, Ariel Sharon and his men would be founder members. Their decision to mount a public performance to humiliate and threaten Mr Arafat interrupted an unprecedented revolt by younger parliamentarians against their eternal leader. The result was predictable: instead of challenging Mr Arafat to give up his executive powers, Palestinians marched in his defence.

In slow motion, by the light of the television cameras, Israeli bulldozers spent last weekend destroying Mr Arafat's Ramallah headquarters, leaving Mr Arafat and about 200 companions cowering in a single wing (see article). The timing of this action was so plainly counter-productive that the charitable suggested that it might be little more than an unthought-out, emotional reaction to the horror of last week's two suicide bombs in Israel, particularly the one in central Tel Aviv.

Yet the cat-and-mouse pursuit of Mr Arafat fits neatly into Israeli tactics that focus on the Palestinian leader and his failings. Mr Sharon has American backing for his refusal to deal with Mr Arafat. And since Israel's prime minister, or so many suspect, would also prefer not to deal with any Palestinian if the bargaining were to lead him to a territorial concession, there is logic to keeping an enfeebled Mr Arafat in place. Meanwhile, the Israeli army continues its bid, as outlined by its chief of staff, to batter the Palestinians into capitulation.

But this, as Kofi Annan, the UN's secretary-general, warned Israel this week, is a bankrupt policy that will not work. The Security Council then passed a resolution that called on Israel immediately to cease its military actions in Ramallah and “expeditiously” to withdraw its army towards the positions it held two years ago. Israel, as usual, took little notice.

This is embarrassing for America, which, with Iraq on its mind, would like to give the Arab world as little cause as possible to compare Israel's attitude to Security Council resolutions to that of Iraq's. Unusually, it abstained on the resolution, rather than vetoing it. But, despite the now rare phenomenon of American displeasure, Israel's siege of Mr Arafat's compound seems set to continue, and its military operations in Gaza are even intensifying.

The new crisis has temporarily blown away the Palestinians' demand for internal change. But it will return. Their parliament, deeply underwhelmed by Mr Arafat's new cabinet, had forced it to resign. Before fresh ministers could be appointed, the building they meet in had been turned to dust.

Elections are the answer

The Palestinians do not wish to follow Israeli-American instructions by unseating their leader. But they do want radical reform. By this, they mean a more competent administration, and a separation of powers between the Palestine Liberation Organisation (the umbrella theoretically sheltering all Palestinians) and the Palestinian Authority. Above all, they want President Arafat to appoint a prime minister—the compromise candidate, acceptable to most, is Mahmoud Abbas, also known as Abu Mazen—to run the West Bank and Gaza.

Mr Arafat's reluctance to relinquish authority is legendary. But he does at least say that he is not against the idea of a prime minister, in principle. He should be pushed hard, by friendly outsiders as well as by his own people, to turn principle into practice. Once he has conceded the change, the democratic way of putting it into effect would be at the elections he has promised for January 20th, but which can take place only if Israel releases the West Bank from its tight bonds of sieges, closures and curfews.

At present Israel's government, with America's encouragement, is determined not to allow elections that would benefit Mr Arafat. This is a mistake, and blatantly undemocratic. Although the old man would almost certainly be re-elected president, a free election would also bring in a larger number of younger, more representative parliamentarians. This is not the sort of regime change that the Americans, let alone the Israelis, might have chosen. But it will be a group more in tune than the old guard were with Palestinian aspirations. And if Mr Arafat has been persuaded to devolve most of his executive responsibilities, it will also be more competent.

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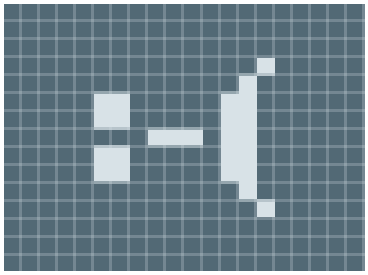
3G telecoms

Let Europe's operators free

Sep 26th 2002
From The Economist print edition

Far from extending their lead in wireless technology, over-regulation has destroyed it



EUROPE'S troubled wireless operators have two big problems. One is the familiar problem of debt, taken on to make pricey acquisitions during the technology bubble and to pay (more than *euro*100 billion—$90 billion) for licences to operate “third generation” (3G) networks. The second problem is less familiar and more technical, but every bit as crippling.

Those expensive 3G licences require the operators to provide 3G coverage by certain deadlines. They also require that they do this using a particular technology, mandated by Europe's regulators at the behest of the European Commission. The technology, called W-CDMA, has just one big hitch: it doesn't work.

Sonera, Finland's national telecoms operator, switched on its fancy 3G network on January 1st. But nobody can use it. Sonera was supposed to launch its 3G services on September 26th via handsets provided by Nokia, the world's largest handset maker and Finland's biggest employer. But the launch was embarrassingly called off because the handsets do not work yet. In Austria, Mobilkom, another 3G operator, launched its 3G network on September 25th, but with a very limited number of handsets. And in Britain, Hutchison 3G, another operator, will begin consumer trials of its 3G service next week, with a mere 1,000 sets.

The difficulty is that the W-CDMA handsets and networks made by different vendors do not yet work together properly. Most operators plan to use network equipment and handsets from several suppliers. Making sure that they all speak the same language looks likely to take another year or two. In the meantime, it is hard to imagine why anyone in Europe would want to buy a 3G phone.

The decision to impose a single technological standard on Europe's operators was intended to reinforce the European lead in wireless technology. In practice, it has had the opposite effect. A recent report from Morgan Stanley concluded that Asia now leads in the adoption of 3G, followed by America. Europe is last. And why have Asia and America pulled ahead? Because they are using a different 3G technology, called CDMA2000, which actually works. Alas, European operators' 3G licences forbid them to use it.

The consumer's best interest

This month the European Commission agreed that 3G operators should be allowed to share sites for their base stations. The anti-competitive risks from co-operation between operators were deemed to be less important than the need to ensure a rapid roll-out of services. In other words, the regulators acknowledged their duty to act in consumers' best interests. Relaxing the technological straitjacket imposed on the operators would be further acknowledgement of that duty.

Admittedly, most of Europe's 3G licences were sold at auction. So granting refunds or relaxing the requirements could set a dangerous precedent for future auctions. But the licences are going to have to be amended anyway if operators cannot meet their deadlines to deliver 3G because they are forced to use a non-working technology.

So operators should be given the option to provide 3G services using technologies other than W-CDMA. Already, some of them are looking at switching to CDMA2000. Most will probably stick with W-CDMA while the bugs are ironed out. But they should at least have the freedom to choose.

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Letters

Sep 26th 2002
From The Economist print edition

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Stopping Saddam

SIR – I wonder at the adverse reaction of many Europeans to the idea that America may go to war with Iraq ("Confronting Iraq", September 14th). Saddam Hussein rules solely by fear, torture and murder. Even if Mr Hussein lets in inspectors to find and destroy weapons of mass destruction, Europe must ask itself whether he and the Baath oligarchy around him should be allowed to stay in power. Surely the free world owes it to the oppressed people of Iraq to rid them of this tyrant? Of course, this invites the question, "Why stop at Iraq?" There are plenty of murderous police-states in the world including most of Iraq's neighbours, but one has to start somewhere.

Neil Wilson
Cape Town

SIR – I agree that Mr Hussein must be replaced. However, wider issues should be addressed to ensure that a world after the demise of Mr Hussein is a safer one. For example, you overlook the fact that Iran is probably much closer to developing a nuclear bomb than Iraq. Also, what must be done to address the growing resentment of the Arab world as America consolidates its presence in the region?

Erico Tavares
Hong Kong

SIR – You assert that an attack on Iraq is justified by a need to counter Mr Hussein's, as yet unseen arsenal. A much more convincing explanation is given in another article in the same issue entitled "Don't mention the O-word".

Chris Greacen
Berkeley, California

Chinese wall

SIR – Your article on censorship of the Internet in China referred to an organisation backed by the Chinese government that calls itself the Internet Society of China ("Stop your searching", September 7th). I want to make it clear that this group is in no way affiliated to the Internet Society (ISOC), a global not-for-profit membership organisation founded in 1991 to provide leadership in Internet-related standards, education and policy development.

The attempt at censorship in China is diametrically opposed to our principles and we would never endorse a pledge to limit the dissemination of information nor similar actions that you describe. ISOC's primary mission is to expand stable and secure use of the Internet worldwide and to encourage openness, transparency and democratic processes. Access to the Internet is an important ingredient in the free flow of information necessary for the long-term welfare of all countries. Government-imposed limitations on access to search engines, as proposed by China, serve neither citizens nor their governments.

Lynn St Amour
President and CEO
Internet Society
Reston, Virginia

Globalisation and the poor

SIR – You rightly correct Thabo Mbeki's gross factual distortion of the effects of the past decade of globalisation ("Sustaining the poor's development", August 31st). Rather than analyse the true costs and benefits of the rise in trade and economic development, Mr Mbeki sides with those whose battle against poverty targets the wealthy rather than the root causes of the problem: disease, illiteracy and ignorance.

What goes unmentioned is Mr Mbeki's staggering hypocrisy. Until recently he denied the true cause of AIDS, and restricted HIV education and the distribution of anti-AIDS drugs to his fellow South Africans (even when offered freely by western companies). In doing so, he is more responsible than most for "the avoidable increase in human misery" for which he blames the developed world. That such gross detachment is reflected in the attitudes of countless southern leaders and northern intellectuals is a measure of how far we have to go before the world's poor are truly free from suffering.

Paul Rushton
Vancouver

SIR – Farm subsidies in developed countries are a necessary and moral way to maintain the ability of a state to feed its people. Without a strong agricultural economy no nation, no matter how powerful, can sustain itself for the long term. The fact that farmers in developing countries can produce and sell foodstuffs at a cheaper price is irrelevant. Developed countries would be foolish to let their farm economies disappear because of the presence of cheap imported food. Food, like oil or any commodity, can be controlled. As the world discovered during the 1970s and 1980s, those who control the supply of a particular commodity have shown no compunction about wielding that power like a club.

I do not mind paying taxes to keep America's farmers farming, steel mills humming and shipyards in business. The ability to sustain liberty and independence demands nothing less.

Mark Carbonaro
Salinas, California

SIR – If sensible environmental policies are to come about, we need to cost damages and price restoration. As with statistics monitoring poverty, disease and corruption we might find that frequent publication of environmental data would be a further measure to hold politicians accountable.

Stefan Waldburger
London

Fair share for the future

SIR – I am glad that you think I do a good job of analysing the pensions crisis in my book "Banking on Death" ("Matters of life and death", August 31st). However, I would like to take issue with the criticism that the share levy I propose is unfeasible since "any company faced with the prospect of being stripped of 20% of its profits would go and accumulate elsewhere."

In fact, a share levy does not strip profits from a company, even though the new shares are calculated as a proportion of company profit. As far as the company is concerned its cash-flow is unaffected. So is the size of the dividend it chooses to distribute. What is changed is simply the composition of the recipients of those dividend payments, which will now include the national-pension board. Thus a share levy is not the same as a corporation tax, with the latter representing a "seizure of profits" (though this is sometimes passed on to consumers through higher prices). The great advantage of a share levy is that it yields income in the future, when pension needs are set to rise steeply.

If we look at the rival approaches to pension reform now before the United States Congress we find that it is the Republicans who propose that companies should be allowed to contribute shares to their employees' retirement funds. It is the approach of Senator Edward Kennedy, which seeks to steer corporations towards cash contributions, that is deemed less business-friendly.

Robin Blackburn
New York

Hitting the right note

SIR – The mention of Louis Armstrong in your obituary of Lionel Hampton (September 7th) brought to mind the finest epitaph I have ever heard. One of Armstrong's fellow jazz musicians said of him, “Louis was born poor, died rich and never hurt anybody.”

James Waters
Wilmington, North Carolina

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About sponsorship

Emigration

Outward bound

Sep 26th 2002
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Do developing countries gain or lose when their brightest talents go abroad?

“THE people I have recruited, I have convinced personally. I have gone to their houses, met their families. They come here because they see this as a challenge.” Edi Rama, the mayor of Tirana, capital of Albania, faces a familiar struggle for a boss these days, to get and keep good staff. But he is fighting for talent in a country where GDP per head is under $4,000—less than a quarter that of neighbouring Greece, where some 500,000 Albanian emigrants now work.

Mr Rama is increasingly in direct competition with much richer countries, too. Canada and Australia, which pioneered “points” schemes to select would-be immigrants with skills, have been tilting these to take an even higher proportion of such people, and the United States has rapidly increased the supply of temporary visas for skilled workers.

Even governments that once strove to keep people out are encouraging the skilled to come in. Germany's recent immigration legislation includes a points system for skilled workers. Britain has rapidly expanded the availability of work permits for skilled migrants, and pushed down the required level of skill. And many countries are softening the rules that normally force foreign students to go home as soon as they graduate. Australia decided last year to allow foreign students of information and communications technology to apply for permanent residence on the basis of their education alone.

About 30% of all highly educated Ghanaians and Sierra Leoneans live abroad

Migrating, legally or illegally, is expensive. So a higher proportion of the well-educated can afford to emigrate than of the poor. In some regions, the discrepancy is staggering. A study by Lindsay Lowell and Allan Findlay for Britain's Department for International Development found that three-quarters of Africa's emigrants have higher (tertiary) education, and roughly half of Asia's and South America's. Of the 1m people from India living in the United States, more than three-quarters of those of working age have a bachelor's degree or better. About 30% of all highly educated Ghanaians and Sierra Leoneans live abroad.

America, the world's biggest skills-magnet, absorbs large proportions of the most educated people from neighbouring countries. A survey of new legal immigrants to America finds that about 21% of them have at least 17 years of education, implying some postgraduate study, compared with only 8% of native-born Americans. Cumulatively, estimates Lindsay Lowell of the Pew Hispanic Centre, a think-tank, 12% of Mexico's population with higher education is in the United States, and 75% of Jamaica's. Such figures are all the more striking because, in poor countries, only about 5% of the young tend to be in higher education.

Not only are the skilled disproportionately likely to leave: it is often the best of the crop. Although about 3% of Indian doctors emigrated in the 1980s, the proportion for graduates of the All India Institute for Medical Sciences, the country's best medical school, was 56% in 1956-80 and 49% in the 1990s. In the case of Mexico, says Agustin Escobar of CIESAS Occidente, a research institute, 12% of the total labour force is in the United States—but 30% of Mexicans with PhDs are there.

America educates one-third of all foreign students

Education abroad aggravates the exodus. America educates one-third of all foreign students and, not surprisingly, about half of all students who get PhDs in the United States are still there five years later. The proportion rises to over 60% for those with doctorates in physical sciences or mathematics. Students from India, China and Britain are especially likely to stay on when their studies are over. Some acquire temporary visas for the skilled: some 23% of holders of H1-B visas in February 2000 had previously held American student visas. Some find American spouses, a quicker and more certain route to legal immigration. And some simply overstay.

Australia and Canada find, to their irritation, that the most skilled immigrants use them as entrepot countries

Poor countries are not the only ones affected by outward migration. Australia and Canada not only lose their own people to the United States. They also find, to their irritation, that the most skilled immigrants use them as entrepot countries, acquiring citizenship and education before moving on to the largest and richest job market in the world.

For Canada, membership of the North American Free-Trade Area has opened the door for a stream of southbound migrants. “They did a quick one on us,” complains Don DeVoretz of Simon Fraser University. For every three Canadians heading south, only one migrant moves north. Again, it is mainly professional people who go. For the past five years, Mr DeVoretz claims, between 15% and 40% of each year's graduating class has headed across the border. Once again, it is the stars who are most likely to leave.

Losing the best

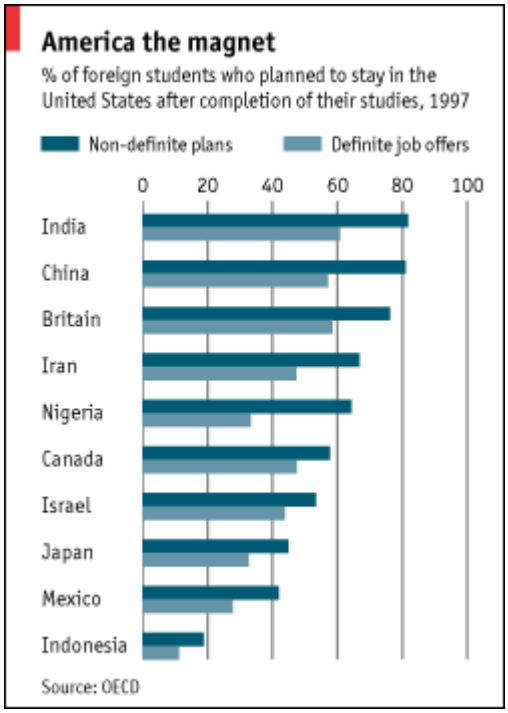
Does it matter if clever people leave in such numbers? For the world as a whole, it makes sense for the cleverest to exercise their skills where they earn the greatest reward. But what holds for the world may not hold for individual countries that lose large swathes of their educated middle class.

Some economists would argue that, overall, the impact of emigration on a sending country may be beneficial. Back in 1882, Knut Wicksell, a Swedish economist, argued that emigration would eventually rid his country of paupers, because poverty was an effect of excess labour and insufficient land. And the behaviour of wages in the main sending and receiving countries in the late 19th century suggests he may have been right. In Ireland, for example, though industrialisation was slow, the economic condition of Irish labourers rapidly improved as the migrants left, both in absolute terms and relative to those in Britain and the United States.

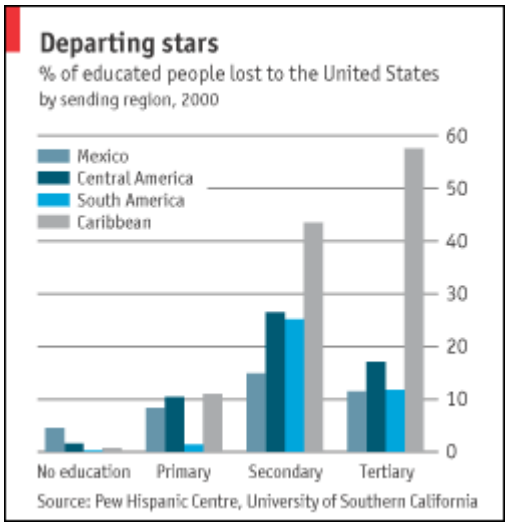
An exodus of the skilled may also raise pay for those left behind. In the mid-1990s, half the graduating physics class at Bucharest University left the country, says Ioan Mihailescu, the university's rector and co-author of a UNESCO study of the impact of the brain drain on the academic labour market in south-east Europe. Last year, that was down to 10%. The reason, he thinks, is that jobs for the highly skilled have grown as Romania's economy has expanded, and so have the wages of people with scientific and technological skills.

However, the loss of the skilled and educated may do more harm than emigration in general. These particular people create new jobs for others. Their departure removes the stabilising political influence of a middle class. And the exodus of scientists and academics wreaks particular havoc, especially if it happens quickly. Albania lost one-third of its qualified people in the decade after the fall of communism. The sheer speed of the exodus left no time for an orderly transition. Moreover, adds Ilir Gedeshi of the Centre for Economic and Social Studies, scientific research projects that take time to conduct fall apart when people leave because, as he puts it, “there is no inherited memory.”

To the loss of productive potential, add the fiscal losses from migration. Taxpayers in developing countries have paid to educate many of those who leave (and who may well end up working in jobs below the level their qualifications would justify at home). And emigration leaves behind fewer workers to pay the cost of looking after the old. Although migrants boost the ranks of taxpayers in the countries they go to, they deplete them in their home country. A recent study of the fiscal effects of the Indian brain drain, by Mihir Desai of Harvard University and two colleagues, points out that the 1m Indians in the United States accounted for a mere 0.1% of India's population but earned the equivalent of a staggering 10% of India's national income. At home, of course, they would have earned far less. But they would still have been among the largest taxpayers.



How far does an outflow of skilled workers bring a reward in the form of remittances? Overall, the sums that migrants send home to developing countries each year are astonishing: some $60 billion through official channels and more—perhaps another $15 billion—in various unreported ways. The inflow to developing countries doubled between 1989 and 2000. Officially reported remittances alone were about 20% more than official development aid over that period. And the gap is widening: official aid is dwindling, whereas remittances are still growing.



Remittances as stimulus

Until quite recently, development experts used to ignore these large flows, or worry that their impacts were mainly negative. Philip Martin of the University of California at Davis, who studied remittances to Turkey in the 1980s, found that they drove up the going rate for dowries, caused inflation of land prices and propped up an overvalued exchange rate. But even if they are spent on consumer goods, remittances may stimulate development, especially if they are spent locally. One study of Mexico suggests that each dollar of remittance generates three dollars of spending power.

In general, though, remittance multipliers have the greatest impact in country districts, which tend to send the unskilled, not the skilled, abroad. And because the most educated are more likely to emigrate with their families and to integrate quickly into their new homeland, they seem less likely to send money back. One of the few attempts to estimate whether remittances by the skilled offset the loss of intellectual capital to the sending country concluded that they did not.

On the other hand, emigration may bring other benefits to the sending country. The possibility of leaving and the higher income to be earned abroad may encourage more people to go into higher education. As not everyone will leave, the result will be a bigger pool of skills than would otherwise be the case. In some countries, the education system is adapting to teach skills needed abroad: in Mexico, for example, the Monterrey Technological Institute has offered for two decades a curriculum and style of teaching designed to meet the demands of American multinationals. But, as Mr Escobar observes, these skills are also useful for their big Mexican competitors.

If those who go abroad subsequently return—a big “if”—they may import useful skills and contacts. And there are also signs that international trade flourishes between countries that export people and countries that import them. One Canadian study found that, during the 1980s, a 10% increase in the

number of immigrants from a given country went with a 1% rise in exports to and a 3% increase in imports from that country. Increasingly, too, entrepreneurs from some Asian countries seem to travel back and forth. Of the 312 companies in the Hsinchu industrial park near Taipei, 113 have been started by American-educated Taiwanese engineers with professional experience in Silicon Valley, where 70 of the park's companies have offices to pick up new recruits and ideas.

Hanging on

What should developing countries do about the loss of skilled workers? Retention is the first line of defence. No country (North Korea and Cuba apart) now tries to stop its people from leaving. A few, such as China, lean heavily on the families of students studying abroad to ensure that they return. But most need to consider ways to make it more attractive to stay at home.

Top of the list should be making a country a good place to work. “I am always struck by how African leaders say they need the return of talent,” says Mr Martin, “and yet my own students try every trick to stay, saying that they are in the wrong tribe, or do not have the right connections to get ahead.” A culture where advancement depends on political affiliation rather than merit will lose bright people to societies where talent is what counts. This is particularly true in the public sector, including the universities, where professionals will stay only if professionalism counts. And countries need other attractions: Tirana's Mr Rama points out that his city did not even have a cinema until two years ago, and donors could not grasp why the lack of one was important.

Pay is vital too. But in order to compete for the brightest, poor countries need to pay them a much larger multiple of the average wage than would be true in the rich world. So global competition for this group will widen income disparities in developing countries. Again, that is a particular problem in the public sector. George Soros's Open Society programme offers one modest solution: it tops up the pay of a small group of elite public-sector workers who have returned to countries in Central and Eastern Europe after being educated abroad. But even that brings problems: graduates who never went abroad to study resent the implication that their degree is worth less.

The way education is financed may have an effect on emigration. Mr DeVoretz calculates that the rate of return for a doctor who gets an education at a first-rate Canadian university and then goes to work in the United States is around 45% on the direct costs of his or her education. University education in Canada is heavily subsidised. If a would-be doctor had to pay the full cost of Canadian medical training, the return on a career south of the border would fall to 15%. Removing such subsidies, or replacing them with loans, would at least partly reduce the incentive to leave.

So, perhaps, might a tax on the diaspora. Jagdish Bhagwati, an economics professor at Columbia University, wants developing countries everywhere to extend their powers to tax their expatriates, in order to reclaim some of the value created abroad by highly skilled emigrants. But the omens are poor. Eritrea is a rare instance of a country that has, since 1993, imposed a tax of 2% of annual income on its expatriates. Apart from the sanction of social disapproval in the diaspora, those who do not pay find it hard to buy or keep land back home, or to get their passports renewed. The impost causes much friction.

But skilled people will continue to leave, and poor countries therefore need to devise ways to draw on their experience abroad. One way to encourage a sense of participating in two cultures, rather than one, is to extend the availability of dual citizenship, something that developing countries have sometimes been reluctant to do. Another is to use the Internet to draw on expat skills and contacts. Jean-Baptiste Meyer, of the French Institute of Research for Development, has traced a growing number of virtual networks that link together a country's expatriate researchers, scientists, students or business folk. Some, such as the Global Korean Network or the Tunisian Scientific Consortium, organise annual conferences to discuss issues of interest to the members and the country of origin. Others undertake joint scientific projects.

A two-way trade

A different approach is to bring back expatriates for short periods, with the guarantee that they will be able to return to their adopted country when their tour of duty is over. The United Nations Development Programme runs one such scheme, called Transfer of Knowledge Through Expatriate Nationals, or TOKTEN, helping skilled expatriates return to work on specific projects. The International Organisation for Migration runs a special project to bring back educated expatriate Afghanis to help with rebuilding their

country. So far, fewer than 300 have returned, but more than 4,000 have registered to do so.

What can the rich countries do? Already, some try not to recruit scarce health workers from poorer lands—although they cannot easily turn workers away who want to come. More usefully, they could put more money into tertiary education in poorer countries, aiming specifically to pay to train the people whom they are going to employ. One modest example: Bucharest university is talking to the Dutch government about teaching the language and other necessary skills to information-technology workers, teachers, nurses and police that the Dutch hope to recruit.

They should also make migration simple, but temporary. The tougher it is for migrants to enter a country, the more reluctant they will be to risk leaving to go home. However, the longer they stay abroad, the more likely their stay is to become permanent. The old contacts go, and it becomes harder to fit in. Mobility, which fits in comfortably with today's employment patterns, is more likely to benefit both sending and receiving countries than the old idea of migrating for good.

Once a developing country starts to grow rich, a return flow will build up of its own accord. Taiwan, South Korea and China all now receive considerable return migration. Ireland, once a land of emigrants, has become a country of net immigration. Given opportunities and political stability, good leadership and the rule of law, many of those who would otherwise leave a developing country will stay—and some of those who left will return.

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Foreign policy

Unprecedented power, colliding ambitions

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From The Economist print edition

Reuters

America's new National Security Strategy is radical, but not in the ways its critics tend to claim

GEORGE BUSH'S “National Security Strategy”, released on September 20th, expounds no new ideas and does not change the focus of America's foreign policy. Nevertheless, it may be one of the most important geopolitical documents produced for a long time. Many people, inside and outside America, have puzzled over the administration's view of the world. They need not do so. The document puts it as clearly as anyone could wish.

It is bracingly blunt, as befits something written, in Mr Bush's words, so “the boys in Lubbock” can read it. Sentence one: “The United States possesses unprecedented—and unequalled—strength and influence in the world.” Might globalisation restrict that power a little? No. The word “globalisation” does not appear. For Mr Bush, American power is what matters. Europeans need to grasp this.

There is no question of softening that power or letting it erode. (“Our forces will be strong enough to dissuade potential adversaries from surpassing or equalling the power of the United States.”) The only question is what that power is used for.

The document spends most of its time on old and recent concerns: free trade, development, even AIDS. (Republicans used to argue that AIDS was not a security issue. No longer.) In some respects, the document has reassuring continuities with President Clinton's world view, though the Bush White House would hate any such comparison. The strategy puts forward no new foreign-policy ideology. It is driven by changing circumstances, notably the Soviet collapse and America's resulting pre-eminence.

Early on, the document draws two clear lessons from the end of the cold war. One, “America is now threatened less by conquering states than we are by failing ones.” Two, cold-war doctrines of deterrence and containment no longer work effectively in a world of “shadowy” terrorist networks. And since this is so, “to forestall or prevent...hostile acts...the United States will, if necessary, act pre-emptively.”

Pre-emption is not new. America has acted pre-emptively before, notably in Central America. And though it now becomes a core part of foreign policy, it sits uneasily beside the statement that “our military must deter threats against US interests, allies and friends.” Deterrence, clearly, is not dead.

A second tension is between the aims of defeating terror and promoting democracy. The document says that America aims to create “a balance of power that favours freedom” and claims that “the world's great powers find ourselves on the same side—united by common dangers.” It moves to and fro as if these

things were the same. They are not.

The first is about promoting values, the second about promoting order. It is simply not true that at the level of government all the world's powers are on the same side in promoting democracy. And some of the steps you might take to defeat threats (cosying up to Saudi Arabia, for instance) conflict with the aim of promoting freedom.

In that respect, argues Ivo Daalder of the Brookings Institution, the document is a faithful reflection of the different strands in the administration: the democracy-promoting “imperialists” such as Paul Wolfowitz, the deputy secretary of defence, who want to change the world; the “offensive realists”, like Donald Rumsfeld, who want to use American power to prevent threats; and the “defensive realists” like Colin Powell, who still see a role for deterrence and for alliances with other countries.

But perhaps the most important influence is that of Condoleezza Rice, the national security adviser. Ms Rice is often regarded as a go-between in the Bush administration's internal wars. There is no discernible Rice world view, as there is a Powell or Rumsfeld one. Yet one may be emerging. The strategy talks a lot about “building good relations among the great powers”—the theme of an article she wrote in *Foreign Affairs* in 2000 (before Mr Bush's election). This is classic *Realpolitik*. The intriguing change now, however, is that these realistic means are being harnessed to more idealistic ends: “The United States must defend liberty and justice because these principles are right and true for all people everywhere.”

If this is so, the tension between promoting democracy and defeating threats will be resolved in favour of promoting democracy. As the document insists, this will be by peaceful means wherever possible, with force used only as a last resort. But the new strategy will nevertheless set America on a course of encouraging change not only in Iraq but in Iran, Saudi Arabia and elsewhere. Let authoritarians take note.

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Re-enter Al Gore

To little effect

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The ex-vice-president hasn't stirred up anti-war feeling

THE most striking feature of America's debate about Iraq is that there isn't one. While Europeans march and yell, America's momentum towards war gathers pace without serious political scrutiny. Might that be changing? Don't bet on it.

For much of the summer, leading Democrats loudly proclaimed that they really, really wanted a debate. They were kidding. They wanted to get back to “kitchen-table” issues. Evidence for this is that as soon as George Bush asked for a congressional resolution backing war, Democratic leaders fell over themselves to sign up.

But now they do have a debate on their hands—courtesy of their former standard-bearer, Al Gore. In a speech in San Francisco on September 23rd, Mr Gore became the most senior politician so far to question the case for war.

He made four points. One, an invasion of Iraq would distract attention from destroying al-Qaeda. Two, by demanding a congressional resolution “in this high political season”, President Bush is politicising the issue. Three, invoking a doctrine of pre-emption is unnecessary in Iraq and bad (because destabilising) elsewhere. Four, by squandering the international sympathy America attracted after September 11th last year, Mr Bush has undermined the coalition against terrorism.

None of these points is new. Brent Scowcroft, national security adviser to George Bush senior, has made the first and the last. Tom Daschle, the leader of the Senate, has accused the president of playing politics. Mr Gore's third point, about pre-emption, has not, however, been debated properly (see article).

But some assertions are dubious, such as the claim that “the vast majority of those who sponsored, planned and implemented [the September 11th attacks] are still at large.” (Didn't the implementers kill themselves?) And some are worse than that, such as Mr Gore's claim that he “felt betrayed by the first Bush administration's hasty departure from the battlefield” in 1991. (In the Senate that year, he had said “I want to state this clearly, President Bush should not be blamed for Saddam Hussein's survival.”)

Still, by virtue of having won the popular vote in 2000, and of having backed war against Iraq in 1991 (unlike most other leading Democrats), Mr Gore carries weight. His speech deserves attention. Whether it will get it is another matter.

Though you would hardly know it from the consensus at the top, a majority of Americans oppose war in Iraq if it were carried out unilaterally. In this week's Gallup poll, only 38% of respondents said they would support American military action in Iraq if undertaken alone; only 37% would support it without congressional support. So you might think that Mr Gore's reservations would strike a chord.

A majority of Americans oppose war in Iraq if it were carried out unilaterally

But support jumps to 79% if American action gets United Nations support, or if other countries join in. Most polls put American support for a war in general (ie, without specifying conditions) at two-thirds. That is extremely high. According to Karlyn Bowman, a poll-watcher at the American Enterprise Institute, polls have never previously shown majority support for a war before it began. Moreover, Americans not only support war, they expect it. That is the most plausible explanation for the sudden jump in the number of those who now call Iraq the most important issue facing the nation, displacing the economy for the first time.

Mostly for that reason, Democratic leaders are likely to ignore both Mr Gore and the rearguard action he has encouraged among a few congressmen. Democrats may try to tone down Mr Bush's proposed (and sweeping) congressional resolution, which would authorise “all means he determines to be appropriate, including force, in order to enforce [UN resolutions], defend the national security interests of the United States against the threat posed by Iraq, and restore international peace and security in the region.” But pass it they will. And then hope to move on to domestic matters.

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About sponsorship

America and Germany

The poisoned relationship

Sep 26th 2002 | WASHINGTON, DC
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And one that will be hard to detoxify

FOR the past few years, Washington's Embassyland has been the site of a war of bricks and mortar. A dozen countries have built embassies the size of palaces in a desperate attempt to outshine their rivals. This building war is a physical expression of a fundamental reality: that there is nothing more important in foreign affairs these days than currying favour with the world's only superpower. Over the past few weeks the German chancellor, Gerhard Schröder, has taken a different tack. As Washington sees it, he has in effect demolished the German embassy and replaced it with a huge neon sign saying “Go to hell, Yankee imperialists.”

The White House simmered in silence while Mr Schröder made opposition to America's Iraq policy (even if sanctioned by the UN) a centrepiece of his re-election campaign. But when his justice minister, Herta Däubler-Gmelin, was reported to have accused George Bush of behaving like Hitler, focusing on a foreign foe to distract attention from his country's domestic woes (a fine example of the pot calling the kettle black), the White House went on the offensive. Both Condoleezza Rice, the national security adviser, and Donald Rumsfeld, the defence secretary, said American-German relations had been “poisoned”.

Mr Schröder is now trying to mend fences. He has sent a personal letter to Mr Bush explaining the remarks of Ms Däubler-Gmelin, who has said that she will not serve in Germany's new administration. But so far the Bush administration is in no mood to kiss and make up. Ari Fleischer, the president's press secretary, complained that Mr Schröder's letter was not an apology (as it was not, since the chancellor did not believe his justice minister had said such a thing). Mr Rumsfeld pointedly snubbed his German counterpart, Peter Strück, at this week's meeting of NATO defence ministers in Poland. (Scheduling problems, said he.) The White House makes it clear in private that it blames Mr Schröder for creating an atmosphere in which crude anti-Americanism has flourished. And there is a real worry that, just as NATO is trying to get an instant-response force set up, Germany will not be willing to play along.

How much longer will the poison last? Germany has already made one substantial attempt at detoxification, promising to take over (in combination with the Dutch) the burden of peacekeeping in Afghanistan. The United States clearly needs Germany's support in rolling up terrorist networks, some of which have flourished among the country's Muslim population. Germany's security services have been some of the most assiduous in monitoring Saddam Hussein's weapons programmes. Most Germans are not wildly anti-American, nor forgetful of America's help against Soviet expansionism. They just have a visceral dislike of “cowboyism”, and think Mr Bush's Iraq policy is a case of it.

But Mr Bush is not a man who is inclined to forgive and forget. He sees politics in highly personal terms: hence his enthusiasm for looking into Vladimir Putin's soul and for inviting world leaders to his ranch in Crawford. He is capable of nursing grudges for years: witness his refusal to invite John McCain to the signing of the McCain-Feingold legislation overhauling campaign finance, perhaps the most important legislative achievement of Mr McCain's career. The new German government will have to work hard if it wants to be friends again.

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The Democrats

We're different. Oops

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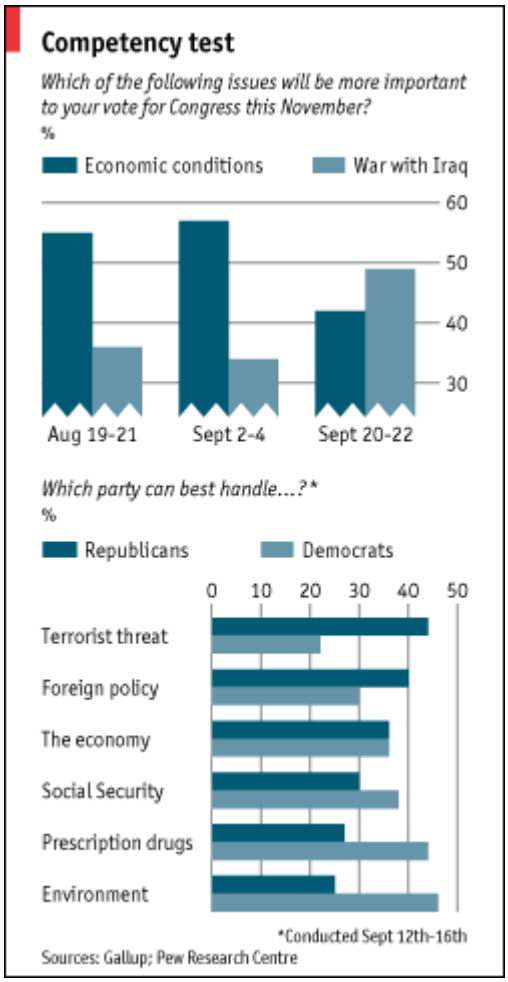
Trying to switch the election debate to domestic policy may well not work

THE Democrats are desperate to change the subject of November's mid-term elections from Iraq to the domestic issues on which voters favour their party by large margins (see chart). The problem is that they may have cause to worry about their home-front ideas, too.

The Senate majority leader, Tom Daschle, gave a speech last week about long-term unemployment (now 1.5m people), dwindling retirement accounts, rising health-insurance costs and thousands of foreclosed mortgages. This leading Democrat blamed the gloomy scene on tax cuts and the return to budget deficits that will hamper government investment in “national defence, education and health”.



But Mr Daschle could offer no coherent way to fix fiscal policy. He stopped short of proposing to rescind or postpone the tax cuts. No wonder: opinion polls show that most Americans want to keep the cuts, and 12 of his Senate colleagues (five of whom are now embroiled in fierce re-election battles) voted for them in 2001. Mr Daschle has similar trouble attacking the budget deficit, because he wants to spend at least $9 billion more than the president in the fiscal year starting on October 1st, which would become $200 billion over the next ten years.

The politics of the budget process further weakens the Democrats' position. Because Congress is so far behind on the 13 bills that will finance the government after September 30th, Congress will surely have to send the president a stop-gap measure to provide temporary money at last year's level. The Democrats will have to accept Mr Bush's conditions for signing the measure, or face a government shut-down like the 1995-96 debacle that wasted 27 days and was blamed on the party controlling Congress at the time. Back then, it was the Republicans; now, at least in the Senate, it is the Democrats.

As his price for letting Congress off this hook, the president wants defence appropriations to pass on time and a total budget closer to the House's $759 billion than the Senate's $768 billion. So the Democrats may find themselves going home—some of them, of course, to fight for their seats—with a handful of Republican priorities and less than they wanted for health care, education and transport.

The Republicans have protected themselves against accusations of being cold-hearted on domestic issues by taking the initiative on a few key bills. House Republicans shepherded a prescription-drug benefit through their chamber in June, whereas the Democrat-controlled Senate only passed a bill to improve the availability of generic drugs, which will pull in fewer votes. The Republican-led House has also passed bills on pensions and welfare. The Senate Democrats were this week able to win over some moderate Republicans to their version of the homeland-security bill, which limits presidential control over federal workers. But this may be a hollow victory, because the Department of Homeland Security is now less likely to become law this year.

Will ordinary Americans notice such subtleties? A survey by the Pew Centre says that only 17% of them are paying close attention to the elections, and a quarter none at all. Anyway, it is not easy for the Democrats to change the subject from Iraq. A Gallup poll released on Tuesday suggests that Iraq is now a more important issue than the economy. One aspiring Democratic presidential contender, Senator John Edwards, said this week that soon Congress “will have dealt with Iraq and we'll be on to other issues.” Even if that were true, it may be too late.

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Street furniture

Is nowhere safe?

Sep 26th 2002 | NEW YORK
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Advertising comes to Upper Manhattan's parking meters

FIRST it was buses, then elevators. Now New York city parking meters will be adorned with propaganda for films, clothes and computers. From October 1st, 500 parking meters on the well-to-do Upper West and Upper East Sides of Manhattan will carry advertising. If the ad spaces are filled all through the year, they could bring the city $90,000—some help in reducing next year's projected $5 billion deficit.

Each meter will be fitted with a three- or four-sided plastic unit, about half-way down the pole, which advertisers will rent from Snap Marketing or Park Place Media. The city will receive roughly 10% of the revenue. Although officials have no say over content, “inappropriate” ads—for tobacco, alcohol, politics or sex—will not be allowed.

Council members and residents from the affected districts have already complained about aesthetics and respect for landmarks. As a result, meters in front of certain historic buildings must be ad-free. And several ad spaces will be designated for charities, public-service announcements and public art.

Some residents argue (this is New York, after all) that they should not have to pay to park at meters with ads, since taxpayers have already paid for the meters themselves. The city's Department of Transportation, which is overseeing the scheme, counters that other publicly-paid-for spaces, such as bus shelters, are already used in the same way.

Four years ago, Park Place Media launched a similar programme in Springfield, Massachusetts, and it is hoping to do so elsewhere in the country. Yet New York intends to proceed slowly before any more of its 64,000 meters are ad-clad. “We are trying to keep an open mind here,” says Tom Cocola, the Department of Transportation spokesman. The ads are “not terribly unobtrusive.”

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About sponsorship

Drug wars

One puff at a time

Sep 26th 2002
From The Economist print edition

The states are loosening drug laws; will Washington follow?

PROHIBITION supposedly divided America, like Gaul, into three parts: wets, drys and hypocrites. Cannabis is now doing the same. One in three adult Americans admits to having tried the herb; most have survived, and some have even gone on to become president. Yet the government still spends billions of dollars trying to save them from it. In 2000, the last year for which figures are available, 734,497 people were arrested on marijuana charges, more than twice the number in 1991. Nine in ten of these “criminals” were guilty of possession alone.

Several European countries have tired of this crusade. Will America follow? The first puff of smoke comes from Nevada, where a chance to legalise marijuana is on November's ballot. Even if Nevadans vote in favour of Question Nine, they will need to do so again in 2004 for the initiative to become law. Yet the aim is clear: to make pot as legal as beer.

Nevada has already moved a step or two in that direction. Two years ago, voters widely approved a measure to legalise marijuana for medicinal purposes. In 2001, the state legislature decriminalised possession of small amounts of the drug. Under Question Nine, anybody older than 20 would be allowed to possess up to three ounces of the stuff—enough for a nice evening in (or at least that's what some guy we met somewhere told us once).

The details of the distribution system are still unclear: would there be special shops and farms, or would anybody be allowed to grow and sell it? But the state legislature would regulate dealers, tax sales of the weed and even subsidise low-cost medical marijuana for some patients, such as AIDS sufferers. The initiative sets out harsh penalties for smoking the drug in public, selling it to children and driving under the influence. Anybody caught selling the drug without a proper licence would be sent to prison.

Advocates argue that a regulated marijuana market would free policemen for other work and give the government more control over the trade. Even the Nevada Conference of Police and Sheriffs, weary of the thankless task of pursuing pot-smokers, endorsed Question Nine at first—though it backed down when its endorsement made headlines, and its president had to resign.

A recent opinion poll shows Nevada's voters rejecting Question Nine by 55% to 40% (5% being unsure). It will probably be much closer than that. A record 110,000 people signed a petition to put the idea on the ballot, with 18-25-year-olds (surprise!) showing particular enthusiasm. Billy Rogers, campaign manager for the artfully named Nevadans for Responsible Law Enforcement, which is pushing the initiative, is confident that Question Nine will pass. This is despite the news that America's drugs tsar, John Walters, will descend on Las Vegas on October 10th to speak out against it. Although he will come armed with plenty of alarming statistics, the pro-cannabites feel his visit will only help their cause. Nevadans do not like federal bureaucrats telling them how to vote.

The state, which already allows legalised prostitution and gambling, may seem an atypically libertarian sort of place. But 11 states have decriminalised possession of small amounts of marijuana, and eight allow use of the drug for medicinal reasons (California, Colorado, Maine, Nevada and Oregon permit both). Recent national polls show 70% of Americans supporting medicinal marijuana and 60% favouring decriminalising possession of small amounts. A number of other ballot initiatives in November reflect this shift. Voters in Arizona will decide whether to decriminalise small amounts of marijuana; and in wide-open San Francisco, red-eyed voters may decide whether the city itself should start growing cannabis.

11 states have decriminalised possession of small amounts of marijuana, and eight allow use of the drug for medicinal reasons

The problem is how to reconcile these states' lenient laws with the stringent federal ones. Last October, the Bush administration began a wide-ranging crackdown on medicinal-marijuana distribution, tearing up patient-run gardens and confiscating doctors' files in California. A group of these doctors has successfully sued the government, though the case has gone to appeal and could eventually reach the Supreme Court. In Santa Cruz on September 17th, medical marijuana was handed out at City Hall in a protest against a federal raid on a cannabis collective. A States' Right to Medical Marijuana Act has attracted 36 co-sponsors in Congress, but seems unlikely to get anywhere this year.

Money may eventually help politicians to change their minds. It costs $1.2 billion a year to keep 60,000 people in prison for marijuana offences. The cost in police time is stunning, too: California is said to have saved $100m a year in enforcement costs by relaxing its laws. By letting Nevada tax the drug, Question Nine would turn the wicked weed into a nice little earner.

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Taxes

Sinning gets expensive

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Continuing bad behaviour spells good news for state budget deficits

ERROL FLYNN famously had trouble reconciling his gross habits with his net income. State governments have no such problem. Desperate to bring their massive (and constitutionally forbidden) budget deficits under control, they have been increasing “sin taxes” on such things as drinking, smoking and gambling. Nevada's proposal to tax cannabis (see article) is merely the most daring of these ploys.

Sin taxes come in two kinds. In the first, the state taxes activities that are allegedly bad for you. In the second, the state itself gets involved in the activity and takes over part of it—by setting up a lottery, for instance.

Nowadays, states are rushing to do both. Tennessee, for instance, has an $800m gap to plug in the fiscal year that ends on June 30th, 2003. It has just increased its cigarette tax by seven cents a packet (bringing in $34.2m) and upped its alcohol tax by 10% ($4.3m). A state lottery ($200m) is on the November ballot.

Smokers are still the most battered sinners. According to the National Conference of State Legislators, politicians in 18 states passed $2.9 billion in new tobacco taxes in the last fiscal year, accounting for nearly half of all new taxes passed. Some of the new taxes were at city level: New York city raised its tax per packet from eight cents to a whopping $1.50. Each pack now costs about $7.

Drinkers get less attention. Alaska and Tennessee were the only two states to pass an alcohol-tax rise this year, but 19 other legislatures have considered it. Several states already levy a betting tax, taking a cut from each bet. Nevada earned $688m this way last year, and may raise the tax from its present 6%. Illinois and Indiana take in an extra $400m a year between them.

Most states like to boast that some of the earnings from such taxes go to public programmes that are intended to discourage the activity in question. On the other hand, they don't want to tax the sin so hard that people stop sinning. One politician seems in earnest: Mayor Michael Bloomberg of New York is trying to ban smoking altogether in large restaurants and bars, suggesting that, for him, the bottom line is secondary to a crusade against the habit. Studies show that a 10% increase in the cost of smoking will lead to a 4% drop in the number of those doing it, rising to 6% among the poorer and less-addicted young.

Sin taxes alone will not cover most states' deficits. Combining all three of Tennessee's sin taxes would not produce half the sum needed. But nor is there much danger that receipts will fall, as long as human nature remains as it is.

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Stem-cell research

The rebel state

Sep 26th 2002 | SAN FRANCISCO
From The Economist print edition

California defies the president

Get article background

CALIFORNIANS do not in general feel much warmth for their governor, Gray Davis. Now, however, the state's scientists feel a new glow. “He should be applauded,” says Helen Blau, a professor of pharmacology at the Stanford University School of Medicine, and so say many others. The governor earned their approval by signing on September 22nd a bill which allows scientists in California to use embryonic stem cells in research. This is in direct defiance of federal limits on the practice.

Stem cells are the raw material out of which developing embryos fashion all the other cells that eventually form a body. Unlike specialised cells that devote themselves to one role—being skin, or making hormones, say—stem cells have the capacity to change into other kinds of cell. They offer a possible means of repairing tissue damaged by degenerative diseases.

But such research worries people who abhor the destruction of human embryos it involves. Many anti-abortion groups have campaigned against it. A bill to ban it altogether is deadlocked in the Senate (as is one that would allow it). The White House is sympathetic to a ban, and last year George Bush issued an executive order that restricted federal money for research to a limited number of existing stocks of previously harvested stem cells.

This federal disapproval has produced a rare brain-drain out of the country. Last year, Roger Pedersen, who led stem-cell research at the University of California in San Francisco (UCSF), left America for Cambridge University. Anxiety about funding has apparently discouraged others from picking up the work. Ms Blau says the limit on federal funding threatens to upset the balance between private and public research.

California's bill, which was introduced by Deborah Ortiz, a state senator who has championed cancer research, explicitly permits the donation and destruction of embryos for stem-cell research. Fertility clinics will be required to tell women that they can give to researchers discarded embryos generated by fertility treatments. Donated stem cells may be multiplied to give scientists more to work with.

Mr Davis has drawn the line somewhere; in another bill, signed the same day, he indefinitely extended the state's ban on reproductive cloning (the permitted research is for so-called therapeutic cloning, which might eventually allow failed organs to be replaced with new versions made from a patient's own cells). But he has still thumbed his nose at Mr Bush and drawn attention to the Republican Party's anti-abortion politics a month and a half before he fights for re-election. The White House looks uncomfortable. At first the president's spokesman said that, as a matter of states' rights, California's decision was of no concern to Mr Bush; but this was amended to say that the president disagreed with Mr Davis and that policies should “respect the culture of life”.

The scientists hope to press their advantage. On September 25th, Ms Ortiz and Mr Pedersen appeared before a Senate hearing on stem-cell research. And California is feeling pleased with itself again.

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Lexington

Ron Kirk's enterprise

Sep 26th 2002
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A black Democrat is making strong moves to uproot the Republican Party from Texas

IN 1964, fresh from signing the Civil Rights Act, a glum Lyndon Johnson complained that the Democrats had just lost the South for a generation. Southern whites promptly confirmed his fears by switching to the Republicans in that year's presidential election. Today, all elected state officials in LBJ's native Texas are from the Grand Old Party, and his old Senate seat has been in Republican hands for 41 years.

Now, just possibly, the curse may be about to be lifted. LBJ's seat is currently up for grabs because of Phil Gramm's retirement. And an affable black Democrat called Ron Kirk is in with a chance of winning. Political races don't come more charged with symbolism than this.

If Mr Kirk wins, he will be an instant superstar: a man who broke the mould of southern politics, struck a blow for black power and gave George Bush a bloody nose in his home state. He will be the only black in the Senate, and only the third to sit in that august body since Reconstruction in the 1870s. He will also be the natural leader of America's black population. The Democrats would be hard-pressed to avoid putting him on their presidential ticket in 2008.

Mr Kirk has earned his reputation as a Democratic Colin Powell by running one of the country's most conservative cities, Dallas, for the past seven years. There, he endeared himself to the city's white corporate upper class by embracing business-friendly policies. This placed him firmly on the pro-business wing of the Texas Democratic Party, among such former luminaries as Lloyd Bentsen (Bill Clinton's first treasury secretary, and the man who gave Mr Kirk his start in politics), John Connally, a vigorous governor in Kennedy's day, and LBJ himself.

Mr Kirk showed his deal-making talent by pushing through a variety of projects—such as a downtown sports arena—that had been languishing for years. But he also proved that he was more than just a corporate schmoozer by working with the city's fractious council and keeping in with the city's black activists.

He is benefiting handsomely from the national interest in his candidacy, persuading his party to devote lots of resources to a state that it recently regarded as a black hole, and starring in fund-raisers in New York and Washington. He also gets some advantage from the fact that he is running on the same ticket as Tony Sanchez, an oil-and-banking tycoon who has so far spent at least $25m on his bid for the governorship—five times as much as his Republican rival—and could well end up spending double that. It would be hard to design a ticket better calculated to boost minority turnout without alienating whites.

This is clearly embarrassing for the Republicans. The last thing they want is a reputation for standing in the way of the state's first black senator and first Hispanic governor. But will it be enough to push Mr Kirk over the top? The smart money in Texas is that it won't: not quite and not yet. The Republican candidate, John Cornyn, may lack Mr Kirk's engaging personality and back-slapping manner. In fact, he may be a bit of a dull bird. But he is a solid enough candidate: a former state attorney-general and former state Supreme Court judge who is running a perfectly competent campaign. He also has the most valuable resource in Texas politics, the support of George Bush.

It is hard for people outside Texas to understand just how popular Mr Bush is in the Lone Star state. Hard-nosed businessmen go misty at the mere mention of his name; fresh-faced young Latinas enthuse about his moral values and solid leadership. Mr Bush is determined to avoid being bloodied by Mr Kirk. He is in the process of making a series of fund-raising visits to Texas, including one to Houston on September 26th. His wife Laura is drumming up support, particularly among suburban women. Karl Rove, an old friend of Mr Cornyn, and Karen Hughes, Mr Bush's former communications director—now back in Austin—are also doing their bit.

But Mr Cornyn got an unexpected boost last week, when Mr Kirk succumbed to a fit of Jesse Jacksonism on the subject of regime-change in Iraq. After pointing out that the people who will be doing the fighting will come largely from minority groups, he wondered whether the Republicans would be so keen to go to war “without any thought of loss” if the first half-million troops to go to the front came from millionaires' families. This jarred with the whites he still needs to enlist. It also exposed a contradiction at the heart of his campaign: the fact that he wants blacks to vote for him because of his colour and whites to vote for him regardless of it. An opinion poll taken after his faux pas showed him trailing Mr Cornyn by 12 points.

The post-civil-rights wave

Still, even if he loses, Mr Kirk's spirited campaign will remain important. He represents the rise of a new generation of pragmatic black politicians: a post-civil-rights generation that sees politics in terms of promoting economic growth which benefits everyone rather than looking for a confrontation with the white overclass. This generation is gaining momentum by the day: look at the careers of Harold Ford junior, the congressman for Memphis, Tennessee, and Shirley Franklin, the new mayor of Atlanta. If Mr Kirk fails, it will still only be a matter of time before another black reaches the Senate.

Mr Kirk also reminds Republicans that they can no longer take Texas for granted. Democratic-leaning minorities now make up 48% of the state's population. The booming high-tech sector lures in out-of-state professionals who have little time for fire-and-brimstone conservatism. Conservative areas such as Mr Bush's adopted home-town of Midland are mired in recession and losing population. The Republicans have already lost California, the mega-state that produced Richard Nixon and Ronald Reagan. Mr Kirk suggests that they may now also be in the process of losing the mega-state that produced the Bush dynasty.

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Dollarisation in Latin America

El Salvador learns to love the greenback

Sep 26th 2002 | SAN SALVADOR
From The Economist print edition

EPA

El Salvador is making a success of dollarisation. But that says as much about the country as the policy

WITH a population of 6m in an area the size of Massachusetts, El Salvador is a small country. But it is not an insignificant one. In the 1980s, its civil war drew the world's eyes. Having achieved peace and democracy a decade ago, it is now being closely watched by a more select group—aficionados of debates about exchange-rate policy. El Salvador is abolishing its currency, the colon, and adopting the dollar. If this succeeds in delivering higher growth, other Central American countries are likely to follow suit.

Two other countries in Latin America also do without their own currency. Panama has used the dollar since it broke away from Colombia, with American support, a century ago. In 2000 Ecuador adopted the greenback, as a desperate measure to stave off hyperinflation. A third country, Argentina, came close to dollarising when its currency's one-to-one peg to the dollar was assaulted by the markets last year, and may yet do so.

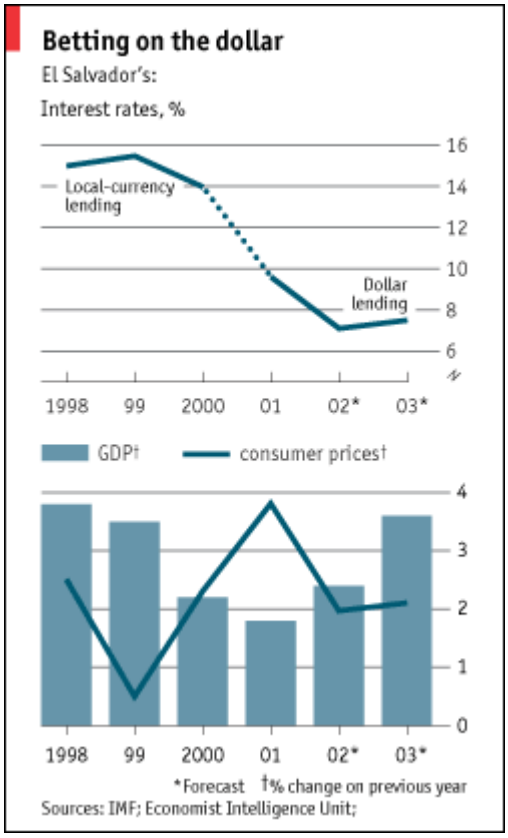
El Salvador's switch to the dollar has been a carefully planned policy, says Miguel Lacayo, the economy minister. The colon was pegged to the dollar back in 1994. Then, in January 2001, the currency began to be phased out. Today, 85% of transactions in the country are in greenbacks, and the dollar is the only unit of account in the financial system. The government expects the colon to disappear completely by the end of 2003.

Dollarisation may well make sense for El Salvador. Its economy, unlike Argentina's, is closely tied to that of the United States, which takes two-thirds of its exports. Some 2m Salvadoreans living in the United States send back almost $2 billion a year in remittances—a sum equal to a seventh of GDP. Most Salvadoreans have been used to handling dollars for years.

El Salvador's economic policies have been geared to the change of currency. Since 1992, successive governments from the conservative Nationalist Republican Alliance party have pursued free-market reforms, privatising much of the economy. El Salvador has combined relatively high growth with low inflation (see chart). Last year, after two devastating earthquakes, growth slowed to 1.8%. But that was still pretty good by most Latin American standards.

Salvadoreans have already started to benefit from dollarisation.

The most obvious gain is lower interest rates. Consumer credit is growing. Companies and the government have been helped by cheaper international financing. And dollarisation has reduced transaction costs for firms.



But dollarisation also poses challenges. Although Guatemala has legalised the dollar as a domestic currency in parallel with its own quetzal, many of El Salvador's other neighbours and economic competitors have floating exchange rates. Their currencies have devalued. To remain competitive, El Salvador has to respond with higher productivity and lower costs. Economic reforms have helped. Take telecommunications: after deregulation in the 1990s, there are now four competing telecoms firms, and charges have fallen. El Salvador also has an unusually flexible and energetic workforce. Foreign investors say this makes up for the second-highest labour costs in Central America.

Even so, there are worries. One is the government's budget deficit. Mainly because of the cost of rebuilding after the earthquakes, that rose to 3.7% of GDP last year. Unchecked, this risks driving up the cost of credit. The government has responded by cutting ministerial budgets by an average of 17% this year.

Businesses, too, have to be nimble. Ricardo Sagrera of Hilasal, a towel manufacturer, says that his firm has had to invest in new designs and production techniques to counter competition from Brazilian and Chinese rivals. GMT, which makes electronic parts for American assembly lines, faces a tougher challenge. Since 2000, its sales have slumped, and its workforce has shrunk from 225 workers to 80. The firm hopes to move back into profit by making more complicated parts, something its workforce can do but competitors, its owner Jaime Hill thinks, cannot.

In short, adopting the dollar is no panacea. To work, it requires deep structural reforms. That is a particularly tough test for Ecuador. Compared with El Salvador, not only is Ecuador's economy less closely linked to that of the United States but its inflation rate is higher, its labour market more rigid, and its economy still unreformed. Its government, too, is pretty profligate—and not because of earthquakes. Depending on who wins next month's presidential election, it is not impossible that Ecuador will end up dropping the dollar and launching its own currency again.

Even in El Salvador, not everyone is convinced. The main opposition party, the former guerrillas of the FMLN, has been against dollarisation. But a section of the party has broken away and formed a more market-friendly social-democratic group. In El Salvador, dollarisation looks irreversible. The fact that manufacturers like Mr Hill still support it shows that many Salvadoreans reckon the pain will be worth it in the end. If they are right, other Central American countries may soon be following in El Salvador's footsteps.

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Canada, the United States and Iraq

Well, maybe ...

Sep 26th 2002 | OTTAWA
From The Economist print edition

Why the Canadian government can't make up its mind

IN THE old days, Canada was usually swift to join military alliances against aggressors. But the government of Jean Chrétien has been notably reluctant to make any public promise to join an attack on Iraq. George Bush's assertion that other countries must be either with or against America in its war on terrorism puts Canada on the spot. How could the superpower's neighbour and biggest trading partner be against? But, where Iraq is concerned, Mr Chrétien and his ministers have been arguing for military action only after seeking a fresh mandate from the UN.

This was the line Mr Chrétien took when the two men met briefly in Detroit (significantly, a hub of cross-border trade) on September 9th. His deputy prime minister, John Manley, went further on September 20th when he said that Canada was unlikely to offer any “additional” military support without UN authorisation. When the foreign-affairs minister, Bill Graham, met Naji Sabri, his Iraqi counterpart, at the UN last week, he said that Canada wholeheartedly supported a tough UN resolution calling for unfettered access by inspectors to all weapons sites; but he has since refused to say whether Canada would support an American-led attack that went ahead without a specific Security Council mandate.

To some extent this wariness reflects Canada's familiar instinct not to want to seem just an extension of the United States. But it is also a reaction to the hesitation shown in opinion polls. Just before the Bush-Chrétien meeting, one poll said that 60% of Canadians thought their country had already given the United States enough support in its war on terrorism. Other surveys suggest that, although a majority of Canadians favour a joint military command structure in North America and support (marginally) a ground invasion of Iraq to change its regime, they doubt Mr Bush's reasons for changing it. Nearly 70% of Canadians also believe that the United States bore some responsibility for the September 11th attacks because of its Middle East policies.

For all that, Canadian forces are likely to be drawn indirectly into any conflict with Iraq, whether or not the Security Council sanctions it. Two Canadian frigates, a destroyer and maritime patrol aircraft are attached to the American aircraft-carrier groups in the Arabian Sea, and B-2 bombers starting from their Missouri base would need to fly through Canadian skies to attack Iraq. These commitments date from the Afghan campaign, and will not be withdrawn. Canada, however, does not want to repeat the experience of Afghanistan, where a Canadian battalion under American command spent futile weeks combing the mountains and in April an American plane mistakenly bombed Canadian troops, killing four of them.

So the Canadians are looking to Hans Blix, the head of the UN Monitoring, Verification and Inspection Commission, who is trying to field an inspection team in Iraq by mid-October. The problem is timing. Ron Cleminson, the Canadian commissioner with the UN inspection body, estimates that it will take up to ten months for inspectors to prepare a definitive report, even with, cross your fingers, full Iraqi co-operation. But the United States may not want to wait that long. Mr Graham foresees an American strike against Iraq in February's cool weather if Saddam's regime is not by then complying with the UN.

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The mess in Paraguay

Plunging into misery

Sep 26th 2002 | SAO PAULO AND ASUNCION
From The Economist print edition

Paraguay blows its chance of a financial rescue

Reuters

Things are looking up for Oviedo

FACED with a three-day protest planned for this week, and after the violent suppression of a demonstration last week, President Luis Gonzalez Macchi, the head of Paraguay's corruption-riddled government, caved in. He partly reversed a recent rise in fuel prices. The transport strike called for September 25th was put on hold, but the government faces bankruptcy.

The protesters also seem likely to win the scrapping of proposed tax rises that the IMF had called for in return for a $200m rescue loan. They are particularly angry that the austerity package the government had agreed on with the Fund was mainly about raising taxes, instead of cutting the inefficient and corrupt public sector, bloated with supporters of Mr Gonzalez's ruling Colorado Party. The bail-out, which James Spalding, the finance minister, had said was the government's only hope of staving off bankruptcy, now looks dead.

National income per head in this South American country of 6m people has been shrinking for seven years. More than half of the population lives in miserably poor conditions. And the depression has intensified this year. The currency, the guarani, has plunged by a quarter. Paraguay's farmers, the most important part of the economy, may fail to obtain new loans to finance this year's harvest: the banks, still waiting for some of last year's repayments, are refusing to give them more money unless the government guarantees the loans. Which, without money from the IMF, or somewhere, it cannot do.

The deeply unpopular Mr Gonzalez admitted this week that he might resign if his party asked him to do so. His vice-president, Julio Cesar Franco, should then take over, but Mr Franco is also expected to resign soon, to seek his Liberal Party's nomination as presidential candidate in next April's election. His failure to do anything has in any case disappointed many Paraguayans, who contemptuously call him “flowerpot”. There is now talk of installing a Supreme Court judge or a senator as stopgap president until the election.

Who can save Paraguay from plunging still deeper into misery? I can, says Lino Oviedo, a former army chief and serial coup-plotter who fled to Brazil in 1999 after being accused of arranging the murder of Luis Argaña, Mr Franco's predecessor as vice-president.

Alas, Mr Oviedo, for all his sins, is probably Paraguay's least unpopular politician, and might well win the presidency if he could run (a conviction over a 1996 coup attempt now disqualifies him). Instead, he is likely to put up a stooge to contest the coming election, hoping that the Supreme Court and Congress can then be quietly leaned on to grant him a full pardon, allowing him to come home triumphantly and run the country from behind the scenes. That many Paraguayans see him as their best hope shows what a dismal state the country is in.

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Mexico's oil troubles

Pemexacerbated

Sep 26th 2002 | MEXICO CITY
From The Economist print edition

Why the oil workers are threatening an explosive strike

FOR the past two weeks, the streets of Mexico's main cities have been echoing to the sound of marching feet. The country's oil workers have been demonstrating in favour of a 15% pay rise, threatening to go on strike on October 2nd if their demand is not met. The nationalised oil monopoly, Petroleos Mexicanos (Pemex), has been offering only 5.5%.

As the deadline nears, the government and the oil union have upped their rhetorical exchanges, warning each other of grave risks if neither of them backs down. A strike would devastate the Mexican economy, as oil still provides the government with over a third of its revenue. The international consequences for global oil markets at a time of confrontation with Iraq could also be severe. With a production of over 3m barrels a day, Pemex is the sixth-largest oil producer in the world. It is also among the largest suppliers to the United States. Worry over the prospects of a strike partly accounted for the 3.5% fall in the peso last week. On September 23rd, the Bank of Mexico had to raise interest rates to shore up the currency.

However, this being Pemex, it is more than just money that has provoked the threat of a mass walkout for the first time since the company was founded in 1938. Long closely tied to the Institutional Revolutionary Party (PRI), which ruled the country for over 70 years until it was defeated in 2000, the union is also protesting against the new government's prosecution of its leader, Carlos Romero Deschamps, who is also a PRI member of congress. He is implicated in a scandal—known as “Pemexgate”—in which about $170m of Pemex money was allegedly fed through the union to support the PRI's failed presidential campaign in 2000. On September 24th, congress authorised prosecutors to start procedures to strip the union leader (and two other PRI legislators and union officials) of their parliamentary immunity so that they can face criminal charges.

President Vicente Fox has pledged to press the case against the union officials as part of his wider commitment to get corruption out of Mexican politics. This is commendable, but the case has soured his relations with the PRI. Unfortunately for Mr Fox, he desperately needs the support of at least some of the PRI's people if he is to push forward his stalled reform agenda, since his National Action Party does not command a majority of the seats in either house of congress.

As *The Economist* went to press, Pemex and the union were trying to find a compromise. A full-blown strike is unlikely, partly because the union's leaders would not have the backing of all its members. But even a relatively small pay rise could push up wage inflation in other parts of the economy, just when the Bank of Mexico is anxiously appealing for restraint.

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Colombia's drug wars

Castaño's gamble

Sep 26th 2002 | MIAMI
From The Economist print edition

Carlos Castaño may be heading for jail

Reuters

Me? A drug dealer?

THE days of Carlos Castaño, the leader of Colombia's outlawed right-wing paramilitaries, appear to be numbered. Mr Castaño is being sought for extradition with two of his aides, accused of shipping 17 tonnes of cocaine to the United States over the last five years. The indictment, announced on September 24th, is part of the American administration's efforts to clamp down on the drug trade that fuels Colombian terrorism. This was also timed to coincide with the visit this week of Colombia's new president, Alvaro Uribe, to the White House.

Mr Uribe is hoping for more, and much needed, economic assistance as he steps up the war back home. Congress has already provided more than $2 billion in the last three years. The Bush administration would like to give Mr Uribe as much help as it can, regarding him as someone who means business, unlike his two weak predecessors, Ernesto Samper and Andres Pastrana. But in order to get Congress fully on side, the Bush administration needs Mr Uribe to show some concrete signs of progress.

Capturing Mr Castaño would help. His arrest would also help silence those on the left who have long complained that Colombia has not done enough to rein in the paramilitaries, responsible for some of the worst atrocities in the country. As the leader of the outlawed United Self-Defence Forces of Colombia (AUC), Mr Castaño has operated with virtual impunity for more than a decade. Colombian military officers have been accused of providing tacit and sometimes active support to the group.

Curiously, Mr Castaño may be ready to turn himself in and says he is willing to stand trial in America in order to clear his name. Though claiming to oppose drug trafficking, he admits that his men collect as much as $200m from taxes on drug producers. It is only money from drugs, he says, that enables his paramilitaries to maintain their fight against Colombia's left-wing FARC guerrillas. “In southern Colombia we have a narco-FARC”, he said in one recent interview. “The paramilitaries can't live off rice.” But living off drugs is a dangerous alternative. Otto Reich, the American State Department's top official for Latin America, says that the AUC is breaking apart because of its “internal contradictions”. Now, he adds, “some groups of paramilitaries are more interested in drug-trafficking than the war.”

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Hong Kong

Death by slow boiling

Sep 26th 2002 | HONG KONG
From The Economist print edition

Are Hong Kong's liberties gradually being taken away?

Get article background

THROW a frog into boiling water and it jumps out; gently bring it to the boil, and the frog, never noticing the incremental increases in heat, allows itself to be cooked. Is Hong Kong a frog in a pot in Beijing's kitchen? If so, then on September 24th the temperature rose another notch.

On that day, Hong Kong's government formally began—by circulating a consultation paper—the process of enacting a controversial set of laws against subversion, sedition, treason and other ills, as required by Article 23 of the Basic Law, the territory's constitution. Overdue and a mere matter of protocol, says the government—something that should have been seen to in 1997, when Hong Kong returned to Chinese sovereignty. An insidious threat to Hong Kong's liberties, counter the critics. If Article 23 could wait for five years, what's the urgency now?

To understand the controversy, it is necessary to know a bit about Article 23's history. The Basic Law came into being during the 1980s and 1990s, as a result of the negotiations between Britain and China about Hong Kong's handover. Its over-arching formula came to be known as “one country, two systems”. Hong Kong, in other words, would remain autonomous, and would enjoy freedoms absent on the Communist mainland. A principal concession to Beijing was a phrase, included in 1988, requiring Hong Kong to prohibit any act “to subvert” the central government.

The problem, however, was that subversion is an alien term to Anglo-Saxon common law, on which Hong Kong's legal system is based. After all, most citizens in free societies regard it as a basic right to subvert—peacefully—their own governments: they call it opposition. So a second draft, in February 1989, replaced “subversion” with “treason, secession, sedition or theft of state secrets”, concepts already defined, if not much invoked.

Then came the Tiananmen Square massacre in June 1989. Hong Kong was horrified at the crimes committed by its future leaders, but the leaders were horrified in turn by the prospect that they might soon have to contend with similar uprisings in Hong Kong, where they would be powerless to crack down. The colony was rocked by huge demonstrations in support of the students. Supplies, money and, perhaps most important, newspapers were sent to them. In the months after the massacre, China insisted on a new draft. The final version of Article 23, in April 1990, restored the requirement for the prohibition of subversion, and added new ones aimed at links between “political bodies” in Hong Kong and abroad.

“Isn't it obvious that, after Tiananmen, Beijing felt threatened and wanted more control?” asks Martin Lee, who helped draft the early versions of the Basic Law and now leads Hong Kong's Democratic Party, the closest thing to an opposition in Hong Kong's toothless and mostly unelected legislature. The fear is that the proposed laws are really targeted at groups such as Falun Gong, a spiritual movement considered an “evil cult” on the mainland but currently legal in Hong Kong. Tung Chee-hwa, Hong Kong's chief executive (pictured above right with Mr Lee), certainly appears to hate having to tolerate Falun Gong in Hong Kong. He might welcome means to brand the group as subversive and deal with it accordingly.

Falun Gong, moreover, is only the most obvious potential target of the new laws. Other dissidents are worried too. So are some journalists and academics, who fret about the clauses regarding theft of state secrets and sedition. Could a research paper on, say, Taiwan-mainland relations constitute a “seditious publication”?

The government, naturally, is working hard to allay these concerns. Not only, it says, has it compared its proposals to existing laws in countries far and wide, it has also complied strictly with international covenants on civil rights in the drafting. Besides, it adds, the point of the whole exercise is only to protect national security, not to limit anybody's freedom of expression. The definitions are tight enough, the government says, that most journalists and dissidents should have nothing to fear.

Ask, for instance, Elsie Leung, Hong Kong's justice secretary, about Falun Gong. She pulls a tome off her shelf and leafs through it to find some fine print that defines political bodies as organisations that “promote or prepare candidates for elections”, under which definition Falun Gong is not a political body in Hong Kong, at least for the present. Or ask Regina Ip, the secretary for security, whether, under the proposed laws, she could extend the mainland ban of Falun Gong to Hong Kong. No, she replies, as Beijing at present does not ban the group on national-security grounds (required for a Hong Kong ban under the new rules) but under a different category, one for “evil cults”. This is meant to be reassuring.

Critics fear this is all part of a pattern, whereby Mr Tung is slowly eroding Hong Kong's checks and balances. In July, he altered Hong Kong's colonial government structure, in which he sat atop an apolitical civil service. He replaced it with one in which he oversees a cabinet of ministers accountable only to himself, who is in turn accountable only to Beijing. It is these ministers who are now drafting Hong Kong's new laws. Every few months, it seems, the water gets a little hotter.

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China

Enlisting gamblers

Sep 26th 2002 | BEIJING
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A cunning way to trap tax-dodgers

BAD times may be looming for Beijing's tax-dodgers. The city's government is introducing a scheme that it hopes will add more than $100m to tax revenues next year by forcing businesses to issue proper receipts. The project involves turning receipts into scratch tickets that offer cash prizes and give consumers an incentive to make sure they are not given counterfeits.

Taiwan has successfully used a variant of this tactic for many years. Now China, faced with a fast-expanding budget deficit, is trying to harness public enthusiasm for lotteries to boost its revenues. Last year, the new system was given a trial run in the capital's satellite town of Huairou. During the year, the town gave out $17,100 in prize money and gained $732,000 in additional tax revenue—a nifty return. From next week, the system will be promoted throughout Beijing's hotels, restaurants and other service establishments.

The new receipts have an “award area” which customers can scratch to reveal either the disappointing word “thanks” or a prize ranging from 100 yuan ($12) to 5,000 yuan ($605). To discourage forgeries, scratching another box reveals a code number. This can be entered, together with the receipt number, on a web page maintained by the Beijing Local Taxation Bureau.

But Beijing's vendors of fake receipts appear to be doing business much as usual. Outside Xizhimen subway station—one of their favourite haunts—peddlers call out “receipts, receipts” to passers-by. They are still selling old-style ones, which are eagerly bought by businesses and individuals hoping to defraud the taxman or their employers.

One man offers fake receipts for all of Beijing's top hotels at 50 yuan ($6.05) apiece—less, if buying in bulk. Another peddler scoffs at the new system. When people need counterfeits of the new receipts, “We will definitely have them,” she says. “We are the best.”

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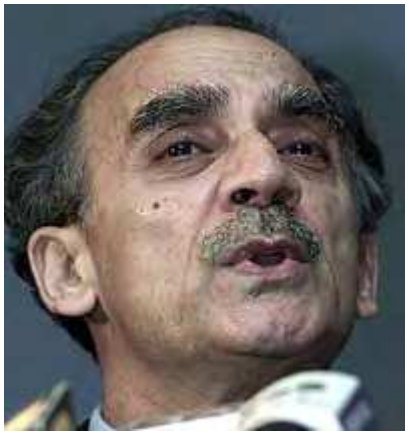
India

Junked

Sep 26th 2002 | DELHI
From The Economist print edition

Shame of the downgraded rupee debt

Reuters



Shourie snookered

NO COUNTRY likes to be reduced to the status of a junk bond, so it is not surprising that a particularly proud and basically stable nation such as India was scornful when Standard & Poor's, a rating agency, downgraded rupee-denominated government debt on September 19th from BBB- to BB+. But India's loss of investment-grade status, and ranking with the likes of Costa Rica and Peru, had little impact on the markets. That was partly because the downgrade was seen as over-harsh when there has been no sudden change in economic fundamentals, and partly because 98% of the government's debt is in domestic markets. S&P cited the government's "growing rupee debt burden" and its "inability to staunch the financial weakening of the public sector". Finance ministry officials replied that India's fiscal deficit had been stable for four years (though it is uncomfortably high at around 11% of GDP, taking central and state budgets together), and that reserves were a record $62 billion.

But S&P did have a point about the public sector. The government has just postponed for three months the sale of its controlling stakes in two refinery and petrol-station companies, BPCL and HPCL. That decision encouraged political opponents of other imminent sales of shipping, aluminium and fertiliser companies to come out of the woodwork, and it now looks as if the government's most active reform initiative may have been halted. Having been ambushed on these sales by his cabinet colleagues, Arun Shourie, the reformist disinvestment minister, shows no signs at present of pursuing plans for privatising these and other corporations.

Adding to the gloom, the government had decided earlier last week to delay a decision on recommendations made by a planning group that foreign direct investment (FDI) restrictions in telecommunications, aviation and insurance should be relaxed. Atal Behari Vajpayee, the prime minister, had hoped to push through these changes to offset the impact of the privatisation delay. He might try again at a cabinet meeting due on September 28th.

FDI inflows touched a record $1.35 billion in the first quarter of this year, boosted by several big items such as the $200m purchase by Suzuki, a Japanese motor manufacturer, of the government's stake in its Maruti car joint-venture. The delayed privatisations would have triggered more such foreign purchases. But India's already shaky reputation as a reliable destination for FDI looks like receiving a further knock from a dispute, which the government is allowing to escalate, between BG (British Gas) and the public-sector Oil & Natural Gas Corporation over operating rights in a successful offshore oil and gas field.

Since the privatisation push began at the beginning of 2000, the control of 12 industrial and service companies has been sold (along with a clutch of hotels) to what are called strategic partners such as Suzuki, bringing 113 billion rupees ($2.3 billion) to the government. Sensing increased market value as potential bidders lined up for future sales, the price of minority government stakes in 32 public-sector businesses listed on the stockmarket rose by more than 70% in the first five months of this year, when the sales momentum was picking up, and then fell back 20% after the negative BPCL and HPCL decisions. Pradip Baijal, the official in charge of disinvestment, says that this shows the benefit of selling controlling stakes to strategic partners, who are willing to bid high prices.

Some critics prefer India's previous practice of floating public sector shares on to the stockmarket because this can delay change and does not pose such an immediate threat to vested interests. That view might prevail. With nine state assembly elections due in the coming year or so, and a general

election in 2004, it seems unlikely that the government will be able to do anything very adventurous.

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Gujarat

Waiting for the big one

Sep 26th 2002 | DELHI
From The Economist print edition

Another atrocity in Gujarat leaves India fearful

Get article background

EPA

Firefighters

IN AN impressive example of what the Indian authorities can achieve when they are determined to prevent riots, the army was staging “flag marches” across the state of Gujarat as *The Economist* went to press. Police and paramilitary security forces were on patrol in major cities and towns throughout the country. All were trying, apparently successfully, to prevent a fresh round of religious violence, after a terrorist siege at a Hindu temple left 30 people dead, and the country's main Hindu fundamentalist group called for a nationwide strike in protest on September 26th.

The siege started late on the afternoon of September 24th when gunmen entered the Akshardham temple complex at Gandhinagar, throwing grenades and firing on worshippers. Some 500 people were rescued from the sprawling complex. The siege ended in the early hours of the following morning, when security forces killed the gunmen.

Gandhinagar is the seat of Gujarat's government, which was condemned earlier this year for standing aside during Hindu-Muslim riots, in which more than 2,000 people are believed to have been killed. Those riots started when 58 Hindu pilgrims were burned alive on a train at the Gujarati town of Godhra. Hindus responded by going on the rampage.

No group has claimed responsibility for the latest attack. But L.K. Advani, India's deputy prime minister, and Narendra Modi, the state's chief minister and a prominent member of the ruling BJP party, both blamed Pakistan—an accusation quickly denied in Islamabad. Letters found on the bodies of a gunman were said to carry the title Tehreek-e-Qassas, an unknown group which Indian officials said could be linked to the Pakistan-based Lashkar-e-Taiba, allegedly involved in an attack on the Indian parliament in New Delhi last December.

Other Indian ministers were more cautious (though blaming Pakistan probably helped reduce the risk of a backlash against the Muslim minority by suggesting that the attack was inspired by politics, not religion). The siege coincided with elections in India's disputed territory of Kashmir which have drawn unexpectedly large turnouts of 40-50% in the first two rounds of voting. Referring indirectly to Pakistan, India's prime minister, Mr Atal Behari Vajpayee said the siege had been staged because opponents of the elections were “jealous” of their success.

Gujarat has been a potential tinderbox since the earlier riots. Mr Modi, one of the country's most controversial politicians, has recently been condemned for making inflammatory remarks against Muslims. He called the relief camps to which they fled during the riots “baby producing centres”. That was a reference to a view held by hardliners that Muslims have large families in order to increase their religion's population in India.

Elections are due in Gujarat by the end of the year and the state is fearful of another outbreak of violence. The BJP has been trying to rein in Mr Modi, lest his extreme views costs them more votes than they win. Politicians such as Mr Advani and Mr Vajpayee, who quickly flew to the scene of the siege, made it clear to him that the attack was not to be used as an excuse for a second round of attacks on

Muslims. “This game of violence and counter-violence has to stop,” Mr Vajpayee said bluntly. Easier said than done.

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Refugees from Malaysia

Island of fear

Sep 26th 2002 | NUNUKAN
From The Economist print edition

Thousands of "illegal" workers flee from Sabah

THE tiny Indonesian island of Nunukan has become a cramped refuge for thousands of Indonesians fleeing from Malaysia, where the government says any caught without work permits face jail and a caning. The government acknowledges that at least 12,000 have arrived, and more come every day. Add the workers' dependants and the number of refugees nearly doubles. Since the influx began last month, at least 70 have died, mostly from preventable diseases according to Post Seven, a Catholic relief agency.

After protests by Indonesia and other countries, Malaysia now says it has suspended its drive against "illegals". It does not care for its flag to be burnt publicly, as it has been in Jakarta. Those who have left Malaysia can return, it says, providing their passports are in order. But the damage has been done.

It looks as though Malaysia, perhaps over-worried that among the Indonesians were members of the dreaded al-Qaeda, has badly misjudged the effects of its policy. Most of the Indonesians fleeing to Nunukan worked in Malaysia's eastern state of Sabah. Some have spent most of their lives there. Although the refugees include mechanics and maids, the largest number by far are plantation workers, mainly employed by Chinese Malaysians growing coffee, cocoa or coconuts. Their lack of passports and work permits has been tolerated. Some desperate employers have now sent them money to return to Sabah. Illegal labour has always been cheap, and can easily be disciplined with threats to report rebellious spirits to the police.

Despite the inconvenience of having thousands of unexpected guests camping in their backyards, the people of Nunukan are quietly benefiting from the influx. They charge those camping nearby for the use of their bathrooms. The Indonesian government has sent in teams of builders to put up huts for officials trying to sort out the mess, all of which means a bit more cash.

Nunukan has long been a base for cheap labour for Sabah, and the 20 or so firms in the business are dealing with applications for passports and work permits. Haji Ramli is one of the biggest operators. He used to be in the people-smuggling business but now, he says, he sends his clients to Malaysia the legal way.

Indonesia is providing free travel to Sulawesi or the other eastern islands the refugees mostly come from. Many have little enthusiasm for returning to Sabah. According to some plantation workers, life is close to slavery, with poor accommodation, a ten-hour working day, and pay the equivalent of about $3 a day. If they have passports, the boss generally takes charge of them. They have three days off a year, Malaysian public holidays.

But, grim as this sounds, it is work. The alternative prospect in Indonesia is joining the country's 40m unemployed.

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Demobilisation in Cambodia

Cam-bodge

Sep 26th 2002 | KOMPONG CHHNANG
From The Economist print edition

Turning swords into ploughshares is proving tricky

EPA

Waiting for civvy street, and maybe a sewing machine

WHEN Pieng Iour joined the army in 1981, Cambodia was already a decade into its 30-year civil war. By the time he was demobilised last year, the endless fighting had not only left the country one of the poorest in Asia, but had also saddled it with an expensive and, in these peaceful days, over-large army. Yet Mr Pieng was able to step down only thanks to a $42m demobilisation scheme paid for by the World Bank and other foreign donors, which aims to equip some 30,000 soldiers whose fighting days are over with the means to earn a living as civilians. Mr Pieng used a $240 grant provided by the scheme to buy half a hectare (1.25 acres) of land on which he has planted rice. A free package of simple tools allowed him to set up house and start working the ground, while handouts of rice kept his family fed until his first harvest. When a promised sewing machine arrives, his wife and daughter hope to supplement the family's income as seamstresses. For a modest investment, his family has been transformed from a burden to the state into contributors to a recovering economy.

But Mr Pieng's neighbour, Ngem Sovantha, also an ex-soldier, has problems. Having spent his $240 on medical bills, he borrowed from a loan-shark to buy a motorbike he uses to ferry his fellow villagers around for a fee. He is due to receive another motorbike under the demobilisation scheme, which he will sell, doubtless at a hefty discount, to pay off his debts. Why, he wonders, could he not have been given its value in money instead?

The World Bank says that it limited the size of cash handouts for fear that officials would steal them or recipients squander them. Nor will it provide two things most ex-soldiers want: land (too many legal disputes) and cows (tricky logistically). Instead, on top of their $240 grants, ex-soldiers can choose one of a range of items, such as a sewing machine, a motorbike or a generator. Like Mr Ngem, many plan to sell these straight away, and spend the proceeds on whatever they really need. That will allow a few local dealers to make a killing from the World Bank's caution. Those who keep their equipment might fare worse: many of the 50 demobilised soldiers in Mr Pieng's district plan to set up tailoring or taxi businesses as soon as their sewing machines or motorbikes arrive. The result of competing businesses, presumably, will be penury all round.

The government seems interested in military reform only as an excuse to prise money from donors. It has not provided details of what extra pensions or benefits the demobilised soldiers might receive, making it impossible to tell whether the programme is generous enough. So far only 15,000 of the nominally 120,000-strong military have been demobilised, all of them old or disabled or both. There are no clear rules about how the remaining 15,000 to be demobbed will be chosen, raising fears that they may have to buy their way on to the list. However the process works, it will leave the army top-heavy, with some 500 generals alone, and short on enlisted men. Because of this, the government periodically threatens to raise more recruits, rendering the exercise pointless. But whenever donors raise objections, as the World Bank did recently, Hun Sen, Cambodia's prime minister, threatens to call off the programme altogether.

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Israel and Palestine

Yasser Arafat amid the ruins

Sep 26th 2002 | JERUSALEM
From The Economist print edition

Getty

He is again under siege, but Israel's impolitic demolition of his compound has made a hero of the Palestinian leader

Get article background

"IT'S just words," said an Israeli official, dismissing a reprimand from George Bush that was more remarkable for its rarity than for its severity. "He has to say them because of the coalition-building against Iraq." Mr Bush had told reporters on September 24th that Israel's destruction at the weekend of all but one of Yasser Arafat's government buildings in Ramallah had been "not helpful". Hours earlier, in another unusual expression of dissent from Israel's unremitting attack on Mr Arafat's regime, America abstained on a UN Security Council resolution demanding that Israel stop pulverising what remains of the complex, and withdraw "expeditiously" from Palestinian cities.

Will Mr Bush leave it at words? A spokesman at the State Department said that America wanted to see the UN resolution enforced, and that this desire was being conveyed to Israel. At the very least, the new, cool tone is likely to head off Israeli plans, leaked earlier in the week, to invade Gaza to get rid of, or deport, senior political leaders in the Islamist Hamas movement.

But a raid into Gaza City on September 23rd left nine Palestinians dead, several of them civilians. Gaza City was attacked again on September 26th when helicopter gunships carried out a raid aimed at Muhammad Dief, who succeeded Salah Shehada (who was killed by the Israelis in July) as head of Hamas's military wing. Non-violent protests briefly flowered in the West Bank this week, but now Hamas is calling for its full revenge.

America, fighting for UN support on Iraq, plainly can do without further escalation in Palestine. But that was just as plain before Mr Sharon ordered his tanks and bulldozers into Ramallah on September 19th, after a gruesome bus-bombing, claimed by Hamas, in the heart of Tel Aviv. That atrocity killed six people, and injured 50, and could, some think, have caused the furious, spontaneous response.

But the demolition work in Ramallah was so patently impolitic and untimely—crushing the delicate international and domestic efforts to engineer some kind of Palestinian regime change, including divesting Mr Arafat of many of his executive powers—that only a conspiracy theory, it seemed, could rationally explain it.

Mr Sharon, some pundits surmise, does not truly want to see a more pragmatic Palestinian leadership evolving, because he would then be required, by Mr Bush for one, to negotiate with the new men over

relinquishing the West Bank and Gaza. This is certainly the view held by some of his far-right and religious political allies. Better, according to the theorists, for Mr Sharon to keep Mr Arafat in place as a convenient punch-bag.

The renewed harassment of Sari Nusseibeh, a prominent Palestinian moderate, appeared to support the conspiracy theory. Mr Nusseibeh has drawn obloquy from Palestinian radicals for his outspoken condemnations of terrorism, and his persistent advocacy of a return to negotiation. Yet, by order of Israel's minister of internal security, his offices in Jerusalem were raided, and then shut down, by the police.

Israel says its tanks and troops will continue to besiege Mr Arafat's last intact building until the Palestinian leader hands over several militants who, Israel now claims, are among the 200-odd guards and officials cooped up with him. The list is curious, including, for instance, Tawfiq Tirawi, a Palestinian intelligence commander who, earlier this year, was regularly holding talks with top Israeli generals and intelligence men.

The Palestinians are convinced that the assault on the compound is a bid to destroy what remains of the Palestinian Authority, and to undermine the nascent movement for its reform. Earlier this month, their newly appointed cabinet had been forced to resign rather than face a confidence vote it was bound to lose. Led by young deputies from Mr Arafat's own Fatah movement, the parliamentarians clamoured for the removal of several ministers long accused of corruption.

And, on September 19th, even as the bus was exploding in Tel Aviv, Mr Arafat was holding a meeting with senior Palestinians who wanted measures to be taken against the terrorists whose violence was in open defiance of Fatah's ban on attacks on Israeli civilians inside Israel. They also demanded that Mr Arafat should appoint his “deputy”, Mahmoud Abbas (Abu Mazen), as prime minister in readiness for the elections that are supposed to be held in January. Mr Arafat supported the first demand. He was less enthusiastic about the second but, according to one participant “was not openly opposed”.

These relative calm waters have now been replaced by turbulence. On the night of September 21st-22nd, thousands of Palestinians, by no means just the young and foolhardy, defied the curfew by taking to the streets of Ramallah and other West Bank and Gazan cities in pot-banging demonstrations. The Israeli army, apart from some wild shooting, in which five Palestinians were killed, mostly held its fire.

Mr Arafat, again under the barrel of Israeli guns, has regained his authority. After a meeting with other Fatah leaders in Ramallah on September 24th, Mr Abbas was at pains to insist that nothing had been discussed other than the siege on Mr Arafat's office and how to end it. “There is no room for discussing the introduction of any changes in the structure of the Palestinian Authority, or creating new positions, at a time when the president is being subjected to the worst aggression,” he said. And Mr Arafat was able to claim that the big West Bank demonstrations were “a referendum” on his leadership.

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Côte d'Ivoire's mutiny

Coups, stratagems and spoils

Sep 26th 2002 | ABIDJAN
From The Economist print edition

EPA

Shaken by mutiny and murder, Côte d'Ivoire is a far cry from its old stability

THE president cancelled his audience with the pope and rushed home. Laurent Gbagbo, Côte d'Ivoire's pious strongman, was in Rome when, at 3am on September 19th, mutinous troops took to the streets of three Ivorian cities. Loyal soldiers swapped bullets and shells with the mutineers. Civilians cowered indoors, unable to tell whether the big-booted heavies outside their doors were shooting to topple the government or to defend it.

It is still not clear what happened, but here is a rough summary. At least 270 people died. The interior minister was killed, probably by rebels. Robert Guei, a former military ruler, was also killed. The government says he was behind the coup attempt, and died in a firefight as he made his way to the national television station to proclaim himself president. But state television showed the normally dapper Mr Guei lying dead on the side of the road in T-shirt and jogging trousers, with a single bullet hole in the side of his head. His relations say that he was murdered in his home, along with his wife, son and grandchildren. Mr Guei had been loudly critical of the government in recent weeks, calling it corrupt and oppressive.

Another prominent opponent of Mr Gbagbo's regime, Alassane Ouattara, was luckier. Troops burst into his home and killed members of his household, but Mr Ouattara escaped to the French embassy. His house was later ransacked and torched. Henri Konan Bédié, the last of the four Big Men of Ivorian politics, at first took refuge in the Canadian embassy, but then emerged and gave a press conference, siding with the government.

When Mr Gbagbo returned, he announced that “the hour of battle has struck” and threatened to unsheathe his blade against “traitors aided by a foreign rogue state” and, of course, “terrorists”. Most Ivorians took this to mean that the coup was backed by neighbouring Burkina Faso, which that country's government hotly denies. Mr Gbagbo promised to clean up “insalubrious areas” of town. Paramilitary gendarmes then burnt down shanty-towns full of migrant workers from Burkina and Mali, who make up much of Côte d'Ivoire's labour force.

By September 25th, forces loyal to Mr Gbagbo had regained control of Abidjan, the commercial capital, and had begun an attack on the second city, Bouaké, where rebels were hunkered down. The northern town of Korhogo was also under rebel control, and rebels were reportedly handing out guns to dissident youths. France, which keeps a permanent garrison in the country, was evacuating foreigners, including 170 mostly American children trapped in a mission school. Nearly 200 American troops flew in to help.

Nigeria sent warplanes to assist the government; Ghana promised to follow suit.

The rebels sent a message, via the minister of sport, whom they captured last week, that they were willing to negotiate. A French consul is acting as an intermediary, and other African states are urging peace. But the defence minister says the government will not negotiate until the rebels lay down their arms, which they are doubtless too nervous to do.

Indeed, many Ivorians have cause to be nervous. Most opposition newspapers have stopped publishing, after the Ministry of Information gave warning that it could not guarantee their security if they published “articles embarrassing to the state”. Foreign radio stations such as the BBC and Radio France International were taken off air on Sunday, and many journalists have fled their homes. The senior state broadcasting regulator said it was “quite usual” in wartime to “manage the media in order not to spread death and disruption among the populace.” State radio is now giving out a number for people to call to denounce treasonous neighbours to the security forces.

The silencing of the press does not make it easier to figure out what is going on. Who exactly are the mutineers? The government says they are men who were recruited into the army when Mr Guei was president, but were about to be laid off, and did not want to be. Time will tell. Meanwhile, the government is furious at speculation that powerful people might have used the coup as a smokescreen to settle scores. Conspiracy theorists note that the murdered minister of the interior had enemies within the ruling party.

The only certainty is that Côte d'Ivoire's fraying reputation as an island of stability in West Africa has taken another heavy knock. From independence in 1960 until 1999, the country suffered no violent changes of government. Then Mr Guei seized power. The next year he was overthrown in a civilian uprising. Since then, the country has been cursed with plots, assassinations and ethnic fighting. As Mr Guei noted the week before he was killed: “Our poor soldiers don't even get time off any more...they're always on alert.”

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Burundi's civil war

The people want peace

Sep 26th 2002 | BUJUMBURA
From The Economist print edition

But the men with guns do not

TWO star-cross'd lovers stand on a small, green hill, fretting that their families hate each other. Mbazumutima and Natalie have been sweethearts since childhood, but his father was murdered by members of her tribe. Characters in “Our Neighbours, Ourselves”, Burundi's most popular radio soap opera, talk a lot about tribal murder, because that, for Burundians, is reality. In 1993, the year Mbazumutima's fictitious father was killed, 250,000 flesh-and-blood Burundians were slain for real. A civil war continues to rage, pitting a government dominated by ethnic Tutsis against largely Hutu rebels.

But the programme does try to show how Hutus and Tutsis can get along, and if listening figures are anything to go by—almost everybody tunes in each week—ordinary Burundians crave peace as much as the programme's creators. The men with guns, however, are not good listeners. On September 22nd, peace talks collapsed after the main rebel group refused even to agree terms for a ceasefire.

Like Rwanda, its northern neighbour, Burundi has been bloodied by fighting between the majority Hutus and the Tutsi minority since its independence. Indeed, the 1994 Rwandan genocide was partly caused by the Burundian massacres of 1993. Bujumbura, the country's pretty capital, is periodically shelled by rebels, either from nearby hills or from gunboats on Lake Tanganyika. On September 9th, at least 183 Hutu villagers were murdered by the army, in reprisal for rebel attacks; the doomed peace talks were then put on hold for two days to allow the rebels to mourn.

Before giving up as mediator last November, Nelson Mandela, South Africa's former president, had some success in bringing the two sides together. He brokered a power-sharing agreement, the Arusha accord, between President Pierre Buyoya's government and several Hutu opposition parties, which produced a transitional government, but no ceasefire.

The rebels reject the transitional government as a poodle of the Tutsi leadership. They have a point. Mindful of what happened in Rwanda, Burundi's ruling Tutsis are afraid to surrender power. There are still no Hutu officers in the army, although thousands of foot-soldiers have been recruited. In May, Mr Buyoya is due to swap jobs with his Hutu deputy, Domitien Ndayizeye. But without a ceasefire, both men may feel too insecure to proceed.

The Hutu-Tutsi conflict is not as ancient as many outsiders suppose. It was deliberately fomented by the very groups now being asked to patch up their differences. The country has been ruled for most of the time since independence by a few Tutsis from the same hill in southern Burundi. Only by stirring up a race war have they managed to unite the rest of their small tribe behind them. The Hutu rebels, for their part, have split into a bewildering number of factions.

With international support, Mr Buyoya could yet defeat the rebels. Last year, South Africa sent 700 peacekeepers to protect members of the new government from the rebels. Rwanda, too, recently sent troops, for fear that Burundi's violence might spill across its border again. Tanzania, home to hundreds of thousands of Burundian refugees, might also send peacekeepers. On October 7th, these countries are to meet to discuss further action.

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Morocco's election

The palace and the politicians

Sep 26th 2002 | RABAT
From The Economist print edition

The Interior Ministry calls the tune, but Morocco's voters are shy of dancing

EPA

Reading what Driss Jettou says

IT MEANT it this time, said the Interior Ministry. Morocco's legislative elections on September 27th would be fraud-free and, under a new proportional-representation system, would produce the first real sounding of political sympathies.

The long-suffering Moroccan public had come to regard politics as a rather dangerous activity for the man or woman in the street, and a rather profitable one for the individuals elected to parliament. Elections have long been rigged by high-level interference and local corruption. Moroccans were promised an honest election in 1997. But, that time, the centre-right Istiqlal Party claimed that it had been robbed of victory by behind-the-scene fixers. It was eventually coaxed into a broad Socialist-led coalition, but has vowed not to repeat this experience.

King Mohammed came to the throne in 1999 promising a new era of openness and democracy. But many of the high hopes that accompanied his accession have faded. The continued high unemployment, the alleged corruption in high and low places, and the shambolic public hospitals are among the main grumbles.

However, this week's vote is the first since Driss Basri, Morocco's interior minister for nearly 20 years and a master of electoral alchemy, was shown the door in late 1999. Driss Jettou, the current minister, is a mild-mannered former shoe manufacturer who heads a team of born-again democrats. They worry about the electorate's high level of illiteracy, which they, and others, see as a big obstacle to the creation of a credible legislature.

Another brake on progress is the score or so of small contenders, with names that typically include the words democratic, national, popular or reform. Once encouraged by the palace as a way of keeping the political landscape fragmented, the tiny parties are now an embarrassment. But most of them will fall at the qualifying threshold of 3% of votes cast.

Even so, the next government is bound to be another coalition, stitched together in discreet inter-party talks. This time, it could well be led by Istiqlal, and include the conservative Islamists of the Justice and Development Party.

The palace remains the final arbiter. The Interior Ministry, which some Moroccans say is the only one that counts, is in its keeping. Four other ministries, including foreign affairs, justice and Islamic affairs, are palace appointments. The king presides over meetings of this select cabinet, which operates in parallel with the prime minister's own cabinet, and takes most of the important policy decisions.

Many politicians chafe under this state of affairs, but none has so far felt ready to go public. And the average Moroccan needs to be convinced there are enough honest and capable politicians around before getting too excited about reclaiming decision-making from the palace.

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Correction

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In our article on Jordan and Iraq ("A Big Mac future", September 21st) we said that Le Royal hotel in Amman was built with Iraqi money. Actually, it is owned by General Mediterranean Holding, whose founder and chairman is Nadhmi Auchi. Mr Auchi is of Iraqi origin but now has a British passport.

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Germany's general election

Gerhard Schröder clings on

Sep 26th 2002 | BERLIN
From The Economist print edition

The incumbent German chancellor has won a cliff-hanging election but with no real mandate for reform

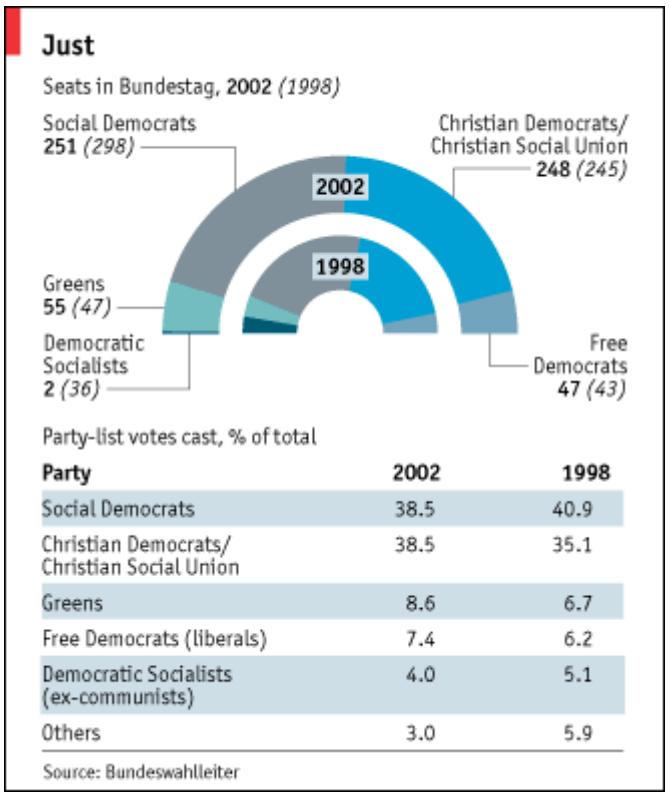
IN ONE of the tightest German elections for half a century, Chancellor Gerhard Schröder's coalition of Social Democrats and Greens managed to cling on to power by its fingertips. Together the pair have 306 seats, a majority of nine in the Bundestag, the lower house of parliament. In the outgoing one, they had a majority of 21, and could usually count on at least the abstention of the 36 ex-communist Democratic Socialists who this time failed to clear the hurdle to obtain any seats by proportional representation and got only two directly elected seats.

Mr Schröder's slim majority will not only make it harder for his government to push through painful reforms but also puts a question-mark over its longevity. Previous governments, notably Helmut Kohl's after 1994, have had equally thin majorities yet have survived; a sitting chancellor can be displaced in mid-term only by a “constructive vote of no confidence”, meaning that parliament has to vote for an alternative administration and not just ditch a beleaguered one.

Still, Mr Schröder will find the going tough. Discipline within the left-wing parties is often loose, particularly among the idiosyncratic Greens. The conservative opposition has gained ground. It already controls the Bundesrat, Germany's upper house, where about half of federal legislation has to be passed. And the economy is continuing to stagnate. Edmund Stoiber, the defeated conservative challenger, says he expects the new government's life to be “very, very short”.

On a night of nerves, with both leaders at different moments claiming victory, the two main formations—the Social Democrats and the combined Christian Democrats and their Bavarian sister party, the Christian Social Union—each got 38.5% of the vote. In the end, the Social Democrats pipped the conservatives, by almost 9,000 votes and three seats. The new Bundestag is expected to have its first sitting in the week that starts on October 14th, with the formal re-election of Mr Schröder as chancellor on the same day or soon after.

With the Social Democrats losing ground since the previous election, in 1998, it was the Greens who kept the ruling coalition afloat. They emerged as the election's only real winners, with 8.6% of the vote, their highest score since they first won seats in parliament in 1983. They are now clearly the country's third force.



Party-list votes cast, % of total

Party	2002	1998
Social Democrats	38.5	40.9
Christian Democrats/ Christian Social Union	38.5	35.1
Greens	8.6	6.7
Free Democrats (liberals)	7.4	6.2
Democratic Socialists (ex-communists)	4.0	5.1
Others	3.0	5.9

Source: Bundeswahlleiter

Barely a year ago, after a string of electoral setbacks, they seemed tired, bland and on the way out. Mr Schröder had even begun eyeing the Free Democrats, Germany's liberals, as alternative coalition partners. But the combined effect of recent floods in the east (which revived many voters' environmental concerns), of the chancellor's stand against a war in Iraq, and of a strong campaign by Joschka Fischer, the Greens' foreign minister and Germany's most popular politician, helped them bounce back. Mr Schröder can thank the Greens for letting him keep his crown. In turn, they will now expect more influence, and say they will press the chancellor to raise the tempo of reform.

The liberals, despite doing a little better than last time, were the election's losers. Their expectations had been high. Pollsters throughout the campaign had put them ahead of the Greens. Only last month, one poll gave them 13%, double the Greens' projected score. They had begun to assume that no government could be formed without them. But they ended up with a modest 7.4%, a point behind the Greens and a far cry from the 18% they had set themselves. A renewed rumpus over anti-Israeli comments by Jürgen Möllemann was partly to blame. He has now resigned as the liberals' deputy leader. But the “fun party” image projected by their leader, Guido Westerwelle, though attracting young voters, may well have put off many of the the party's older, more earnest supporters. Many Germans think Mr Westerwelle lacks gravitas.

Despite failing to hit all three of his proclaimed targets—to have the biggest group in parliament, to win more than 40% of the vote, and to topple the government—Mr Stoiber has emerged beaten but unbowed. His conservatives upped their 1998 vote by more than three percentage points, while the Social Democrats dipped by a couple. In Mr Stoiber's Bavarian homeland, his party's share shot up by 10.9 points to 58.6%, its best score in nearly two decades. Indeed, with 9% of the total national vote, Mr Stoiber's Christian Social Union can claim to be Germany's third biggest party, ahead of the Greens. He says he has no intention of retiring quietly back to his home state but stands ready to take the chancellor's job should the government collapse.

Were it not for last month's floods in the east and the threat of an American-led war in Iraq, Mr Schröder would probably have failed to win a second term. Neither event was of his making, of course. But he exploited them both to his benefit. As a result, says Donald Rumsfeld, the American defence secretary, relations between Germany and the United States have been “poisoned”. He refused even to talk to his German counterpart at this week's meeting of NATO defence ministers in Warsaw, and President George Bush failed to send Mr Schröder the customary congratulations. The chancellor is eager for reconciliation and has even asked Britain's Tony Blair to help. But he insists that there will be “no change” in his opposition to Germany's participation in an attack on Iraq, even under a United Nations mandate.

This, says Mr Schröder, is “a difference of opinion” that should be accepted among friends; the relationship, he insists, is “intact”. That is not the view in Washington (see article). Matters were not

helped last week by the German justice minister, who was accused of lumping Mr Bush with Hitler by saying that the American president has sought to distract voters from problems at home by talk of war—tactics, she is said to have added, that were once used by “Adolf Nazi”. She has denied making the remarks, but says she will resign anyway. Relations between the countries, and between Mr Schröder and Mr Bush, who have not talked since June, remain strained.

It is on the home front, however, that Mr Schröder faces his hardest task. Speeding up Germany's dismal growth rate, creating jobs and loosening the country's labour rigidities should be his top priorities. But the election does not suggest that the German people have an appetite for radical reform. Mr Schröder has no mandate for it. Nor would Mr Stoiber, if he had won. That is the election's gloomiest lesson.

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The poll in Germany's east

A final communist collapse?

Sep 26th 2002 | ROSTOCK
From The Economist print edition

In Germany's east, the party that once ran the show may be dying

"MECKLENBURG-WEST POMERANIA is turning into a high-tech state!" boomed the stocky bearded man on the platform. "It'll be the best place for business in eastern Germany!" The loyal crowd huddling under umbrellas in the beautifully restored medieval market-place of Rostock, on the Baltic coast, looked bemused. Most of them like their Social Democratic state premier, Harald Ringstorff, a former chemist, and have nothing against his coalition with the ex-communist Democratic Socialists, though it aroused controversy when it was created four years ago. But the idea that the economy of the northernmost of the former East Germany's five states is forging ahead strikes the crowd as laughable.

Last year it shrank by 0.8%. Unemployment stands at 18%, the same as when Mr Ringstorff took office. Yet in the state election, held on the same day as Germany's general election, 41% opted for his Social Democrats, six percentage points more than in 1998. Though the Democratic Socialists' vote fell by eight points to 16%, Mr Ringstorff's "red-red" coalition is intact.

In the general election, the Democratic Socialists did badly throughout the former communist east. Their share of the vote there fell from 22% in 1998 to less than 17%. In the west, they polled a mere 1%, the same as in 1998, giving them an overall nationwide score of 4%, a percentage point below the threshold normally required to enable a party to form an official group in the Bundestag, Germany's lower house of parliament. If the ex-communists had won three individual seats despite failing to cross the 5% national threshold, they could still have retained the right to an allocation of seats in proportion to their total national vote. But they won only two directly mandated seats—so that will be their sole tally in the new parliament. In 1998, when they polled just 5.1% nationwide, they were granted 36 seats, despite winning only four directly elected ones.

Is this the beginning of the end for the heirs to East Germany's communist rulers? It looks that way. Their participation in ruling coalitions in the city-state of Berlin as well as in Mecklenburg-West Pomerania has deprived them of their identity as a protest party. Their failure to make a mark during last month's floods in the east sullied their image as the area's true guardians. And the resignation in July of Gregor Gysi as Berlin's economics minister over an air-miles scandal robbed them of a star. It is chilly without one.

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Belgium's language wars

Tongue lashings

Sep 26th 2002 | BRUSSELS
From The Economist print edition

Rows over who should speak in which tongue have got worse

THE tensions between Dutch- and French-speakers are usually a source of private grief to the Belgians. Now their never-ending row has gone international. The Council of Europe, a human-rights watchdog which groups together 44 European countries, has rebuked Belgium for violating minority rights. How come?

The problem has its roots in the sensitive area around Brussels where the French-speaking Walloons and the Dutch-speaking Flemings live side by side. The Flemings harbour a special grievance about the city, for it was once predominantly Flemish, and some Flemings still hope it may yet be the capital of an independent state of Flanders. But demographic change means that 80% of its inhabitants now speak French. This has made the Flemings all the more determined to insist on the use of Dutch in the Flemish areas around the city.

If you live anywhere in Flanders, they say, you should speak Dutch—with no exceptions for the 120,000 Walloons living in Brussels's periphery. All local council proceedings must be in Dutch, even in a couple of communes where the mayor and most local politicians are Walloon. All official letters must, in theory, be sent out only in Dutch. Libraries stocking too many French books will lose their subsidies. Walloons who turn up at local councils unable to speak Dutch must bring translators. This infuriates the francophones, since they are quite sure the officials behind the counter can speak French. “We can speak your language, so why don't you learn ours?”, the Flemings respond.

For some years a group of Walloon protesters around Brussels has been indulging in civil disobedience. Some refuse to speak Dutch in local shops. Others won't pay local taxes on the ground that the demands are written in Dutch. In 1998 some Walloons had the bright idea of petitioning the Council of Europe. An investigator concluded that Belgium should sign the European convention on minorities' rights, to bolster Walloon rights. But nothing happened. So the Council of Europe has written another report, scolding Belgium for ignoring its earlier recommendations. The council's parliamentary assembly was due to debate the issue this week.

Relations between Belgium's two main groups are anyway more fraught than usual. The national government almost broke up recently when Flemish Greens threatened to resign from the government (one of them did) in protest against arms exports to Nepal from a factory in the Walloon bit of Belgium. The Council of Europe report will stir more bad blood but won't help the Walloons. Though Belgium has now signed the council's convention on protecting minorities, all seven of its regional and national parliaments have to ratify it to give it legal force. But do not expect the Flemish parliament to sign up.

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Spain and the Basques

An ugly mood

Sep 26th 2002 | MADRID
From The Economist print edition

Spain struggles to silence the party that speaks for Basque terrorism

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AP

ETA's serpentine mural message

BANNING the political mouthpiece of the Basque separatist terrorist group, ETA, is proving a mixed blessing. Security people in Madrid point hopefully to some big recent setbacks suffered by the terrorists and say that the political ban on Batasuna, ETA's hitherto legal political arm, is helping to throw the terrorists on the defensive. Politics, however, is another matter. Relations between the government in Madrid and the non-violent Basques who run their own regional government have rarely, if ever, been worse.

In the security field, the picture brightened a fortnight ago when two top terrorists were nabbed in France. ETA has been slower than usual to hit back with its usual reply—more terrorism—and seems likelier nowadays to botch its operations. Earlier this week, two terrorists accidentally blew themselves up in Bilbao, the region's biggest city. For sure, the killers have not entirely lost their lethal skills. The day after that accident, a booby-trapped Batasuna banner in another Basque town killed a civil guard, bringing the number of ETA's fatal victims this year to four. But that is far fewer than in the mid-1980s, when ETA was killing nearly 100 people a year.

In any event, Basque politics, both in the region and in Madrid, the Spanish capital, have become a lot more complicated. In particular, the main non-violent Basque party, the Basque Nationalists, better known by their initials PNV, who run the region's government, fiercely oppose the ban on Batasuna. Hence the ill-feeling between the region's rulers and Spain's national government in Madrid, run by Jose Maria Aznar and his conservatives.

Moreover, the procedure for banning Batasuna is proving by no means simple. That is because there are two prongs to the process. The first is being wielded by Baltasar Garzon, a prominent judge, who took the initiative last month to suspend Batasuna in the name of one of Spain's highest courts. The second is being wielded by the government in Madrid, which must prove that Batasuna should be banned under a specially amended law on the obligations of political parties which it recently enacted with Batasuna in mind.

To complicate matters more, the non-violent PNV, who run the region, are not entirely at one. The Basque premier, Juan Jose Ibarretxe, did his best to obey Mr Garzon's order that Batasuna's headquarters be closed down. But the PNV's veteran leader, Xabier Arzalluz, is more belligerent—and more loth to co-operate. He has likened Mr Aznar's policy towards the Basques to that of General Franco, who clamped down ruthlessly on Basque (and Catalan) nationalists. Mr Ibarretxe and his government, however, are still trying to keep within the new law—by challenging Mr Garzon's ruling in higher courts.

But the Basque regional assembly, also controlled by the PNV, has gone a step further than Mr Ibarretxe's Basque government by declaring Mr Garzon's ruling invalid. So it is refusing to suspend the assembly's Batasuna members, who still enjoy their parliamentary privileges.

That in turn has prompted calls in Madrid, mainly by conservatives but by some Socialists too, to suspend part or all of the self-government Basques enjoy under the system of regional devolution

enshrined in the post-Franco constitution, which makes provision for this if a region “fails to meet its constitutional or other legal obligations and poses a serious threat to the general interests of Spain”. Mr Aznar says that his government has not yet contemplated taking so drastic a step. But some of his supporters are pressing him to do so.

“We never said the ban was going to be a panacea,” says one of Mr Aznar's aides. “But it is morally right.” The government argues that, after years of giving way to nationalist demands, it is time to defend the rights of those in the Basque region who want it to stay fully part of Spain and are subjected to intimidation and violence by the separatists. The PNV ripostes that when the current constitution of 1978 was approved in a referendum, it abstained. Since the moves to ban Batasuna, such differences between non-violent politicians over how the Basque country should be run have become even more bitter.

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Ireland's coming EU referendum

Still nerve-racking

Sep 26th 2002 | DUBLIN
From The Economist print edition

This time the Irish seem likely to say yes. But you can't yet bank on them

“SAME bad treaty! Don't be bullied! Vote No to Nice!” says the blunt message on the poster tied to the lamppost outside parliament in Dublin. The words are set against the backdrop of a man with a gun pointed at his head. They refer to the treaty that was agreed upon by the European Union's 15 governments in December 2000 but rejected by Irish voters in a referendum in June last year. On October 19th, they will vote on it once again.

At stake for the EU are its plans for taking in up to ten new countries, mostly from Central Europe, and for streamlining the EU's decision-making methods to cope with the influx. The other 14 countries already in the club have all ratified the treaty. Only Ireland's endorsement is lacking. At stake for Ireland, say Irish advocates of a yes vote, is their country's place in the EU. It must either remain at the heart of European decision-making or find itself isolated and friendless at the margin.

Since being rebuffed by Ireland in the first referendum, the EU has declared that its proclaimed common foreign and security policy will not force traditionally neutral countries, such as Ireland, into becoming part of a new European defence axis. But the Irish government is focusing its campaign less on the merits of the treaty and more on Ireland's overall future in Europe. It is stressing the economic gains of membership more zealously, and warning voters that a second rejection could threaten Irish jobs by deterring foreign investors. It points out that in Ireland's 30 years in the EU it has become rich, with GDP per head now at 122% of the Union's average. Yet the country is still a net beneficiary of the EU budget—this year to the tune of some *euro*1.5 billion ($1.5 billion).

Fianna Fail, the main party in the newly re-elected centre-right coalition government led by Bertie Ahern, is spending ten times more on the referendum campaign than it did last time. And the pro-treaty side has drafted in some big guns, such as former European commissioners, Peter Sutherland and Ray MacSharry, and the European Parliament's current Irish president, Pat Cox, to pep up its supporters.

This intensified yes campaign is paying off—so far. Polls give the treaty's supporters a two-to-one advantage. If there is a danger, it is that the government itself is having an unpopular spell and that on referendum day voters might choose to punish it by voting against Nice.

Many voters are annoyed by what they see as a series of post-election U-turns on spending. Earlier this month Mr Ahern decided to scrap his longstanding plan for a state-financed national stadium, known popularly as “the Bertie Bowl”, leaving taxpayers with a hefty bill for costs already incurred. This week the finance minister, Charlie McCreevy, who had promised during the election campaign in May that “no cutbacks whatsoever are being planned, secretly or otherwise”, was embarrassed by the leak of a confidential plan for cuts worth *euro*900m in the next budget.

All this has undermined the government. Even the opposition parties that support the treaty have told their voters not to use the referendum as a chance to punish the government by voting no.

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Slovakia's election

Phew! The winner lost

Sep 26th 2002 | BRATISLAVA
From The Economist print edition

An alliance of the respectable keeps out a dangerous old roughneck

A THUGGISH populist topped the poll. A smarmier, less belligerent one was third. But a group of four more respectable parties on the centre-right (one of them also populist and untested) won just enough seats between them to form Slovakia's next government. That, for a country striving to join mainstream Europe, is reckoned a stirring success.

The party led by Vladimir Meciar, the strongman who woefully misruled Slovakia from 1993 until 1998, came top in a general election for the fourth time in a row since Slovaks and Czechs divorced nine years ago, but he has again been kept out of power because no other party has any wish to team up with his. As a result, Slovakia looks set to be invited, later this year, to join both NATO and the European Union.

All the same, it is a gloomy fact that nearly half of all Slovak voters plumped for populist or nationalist parties whose credentials are, to say the least, dodgy. Mr Meciar got nearly 20%, down from 27% at the last general election four years ago and from the 35% he won just after the split from the Czechs. So his popularity is undeniably dipping. Robert Fico, a younger, slicker and more stable version of the volatile Mr Meciar, came third with nearly 14%. The unreformed Communist Party got 6%, winning seats for the first time in post-communist Slovakia's history by doing especially well in the country's decrepit east, where unemployment is sky-high. A nationalist party and a group that had splintered from Meciar's lot won 7%, though both failed to cross the 5% threshold needed to get seats in parliament.

Still, the centre-right fared more robustly than expected. The Democratic and Christian Union of Mikulas Dzurinda, the incumbent prime minister, came second with 15%. He is expected to team up with an ethnic Hungarian party, which got 11%, the Christian Democrats with 8%, and the Alliance of New Citizens, known by its acronym ANO (meaning Yes), a new outfit on the right headed by Pavol Rusko, a television magnate, which also got 8%. This reform-minded four-way coalition (similar to the last one, plus ANO) will have 78 seats in parliament, giving it a majority of three. Mr Dzurinda is expected to stay on as prime minister, though some say his foreign minister, Edward Kukan, could displace him.

Most democratic-minded Slovaks are heaving a sigh of relief, mainly because their country's bid to join the West now looks likely to succeed. Beyond that, though, all is not well. Corruption among Slovakia's ruling politicians and leading businessmen is rife. Disgruntlement is widespread. The protest vote was big. Mr Dzurinda, or whoever runs Slovakia, has little time to lose if the populists are to be kept at bay in four years' time—or perhaps a lot sooner.

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Turkey's coming election

The front-runner mustn't run

Sep 26th 2002 | ANKARA
From The Economist print edition

Banning the country's most popular politician may give his party a boost

EPA

ONLY last month, Turkey's European friends were cheering the country's habitually squabbling MPs after they had voted for a big batch of reforms to make Turkey much more democratic. But their optimism has been dented by last week's decision of the country's electoral board that the man tipped to be the next prime minister cannot run for parliament.

According to the board, Recep Tayyip Erdogan (above), who leads the newly formed Justice and Development party, or AK, which means “white” or “clean” in Turkish, cannot run because of a past conviction for reciting verses that, the judges said, “incited religious hatred”. No matter that the poem was penned 90 years ago by a nationalist poet and is taught in schools.

And no matter, apparently, that the scope of free speech was much broadened by last month's constitutional changes. Hikmet Sami Turk, the former justice minister who helped to draft these new laws, says they expunged Mr Erdogan's past offence. But the fierce head of Turkey's appeals court, Sabih Kanadoglu, insists that under Turkish law Mr Erdogan has been banned from politics for life—and that's that. For the same reason, Murat Bozlak, leader of Turkey's biggest pro-Kurdish party, Hadep, has been prevented from running for parliament. So has Akin Birdal, a leading human-rights campaigner. These harsh decisions might be sustainable but for the fact that the board has given the electoral go-ahead to a number of unsavoury characters, such as Oral Celik, a convicted drugs smuggler.

It is true that Mr Erdogan began his career in an openly Islamist party that railed against the West. “My frame of reference is Islam,” he proclaimed. But since being forced out of his job as mayor of Istanbul in 1998, and spending four months in jail over the affair of the poem, he has changed his tune. First he broke ranks with Necmettin Erbakan, his old mentor, who was Turkey's first Islamist prime minister and was himself shoved out of power in 1997 by the country's meddlesome generals. Then Mr Erdogan set up AK. And now he says he wants Turkey to join the European Union, stay cosy with the United States, and stick to a huge fiscal-reform package being financed by the IMF. He insists he is not, and never has been, an Islamist.

Whether or not most Turks believe in his conversion, a lot of them clearly think Mr Erdogan is fit to run Turkey. Opinion polls consistently suggest that AK might get 25-30% of the vote—a good ten points more than its closest rival, the stodgily secular Republican People's Party. Mr Erdogan has promised to keep campaigning and has refused to name a successor to lead his party in the election fray.

His exclusion may even draw extra sympathy votes for AK, perhaps even give it an outright majority in parliament. That would be a nightmare not only for the army but for some of Turkey's industrialists, who live mainly in the Istanbul area and have for decades grown fat on the patronage dispensed by the crooked politicians of the country's mainstream parties. AK, they fear, might favour the more ostentatiously religious sort of businessmen in the Anatolian hinterland, who have been chipping away at Istanbul's economic dominance since the time of the late Turgut Ozal, Turkey's visionary leader in the late 1980s and early 1990s. Banning Mr Erdogan could have precisely the opposite effect to what the generals intended.

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AIDS in Russia

A looming plague

Sep 26th 2002 | ST PETERSBURG
From The Economist print edition

Russia is hopelessly ill-prepared for the coming epidemic of AIDS

Get article background

ANDREI now realises it was a mistake to tell his dentist to don surgical gloves before tackling his tooth. It was an even bigger one to admit he was HIV-positive. The dentist simply refused to operate. Andrei now says that in future he will keep his condition secret, even if that puts others at risk. “If I try to be considerate, I get discriminated against. What choice do I have?”

Three years into what may be the world's fastest-growing HIV epidemic, Russia can offer victims only discrimination and despair. Since 1998, the number of registered HIV cases in the country has jumped almost 20-fold, from some 11,000 to nearly 200,000 in May this year. Compared with Africa, this sounds low. But the real Russian figure may be between three and ten times higher. The state health agency puts the number of infected people at 1m, some 80% of them under 30.

Russia's worst-hit city is St Petersburg. At the end of 2001 it had registered more than 17,000 cases; local health authorities say 97% of them are drug-users. But some experts say the number of cases in the city is about three times higher.

St Petersburg is one of the few places in Russia where the authorities have let non-governmental organisations conduct free, anonymous HIV tests and distribute syringes and condoms. A group called Doctors of the World is the largest outfit trying to reach the city's prostitutes, most of whom take heroin. Its head, Alexander Tsekhanovich, believes infection among drug users has peaked; it is now spreading through sex. But Russia offers little sex education and promiscuity abounds. Researchers from the University of North Carolina found last year that 44% of teenagers had not used a condom last time they had sex.

Russia's decrepit health system is at a loss. Most doctors are frightened of being infected. Discrimination against HIV-positive people is rampant. Their condition is marked down in the “medical passports” which companies still demand from job applicants; few employers want them. Doctors sometimes refuse to treat them. A recent poll found nearly one-third of Russians wanted to quarantine people with HIV.

As in Africa, anti-retroviral therapy, which helps postpone the onset of AIDS, is generally thought to be too expensive, at around $1,000 a month per person. In St Petersburg only about 100 people, mostly medical staff infected in the course of their work, receive it. Most medical workers now undergo HIV tests several times a year. So do pregnant women, soldiers and prisoners. Only in St Petersburg are tests more common: some 700,000 people, about every seventh inhabitant, receive annual tests.

The first big wave of AIDS-connected deaths will probably hit Russia in 2007 or so. By then, it is feared, some 2-3% of its people will be HIV-positive. So far the medical service is hopelessly ill-prepared. “Being HIV-positive in Russia is not a diagnosis,” says one of St Petersburg's leading AIDS doctors. “It's a sentence of death.”

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Charlemagne

Left, right, left

Sep 26th 2002
From The Economist print edition

Why political taboos are being broken in Europe

THE Germans invented the word *Zeitgeist*, but anyone hoping that their latest election would confirm a new "spirit of the age" in Europe will have been disappointed. In the past year or so, a clear trend seemed visible. Left-wing governments were ousted by the right in Italy, France, the Netherlands, Denmark, Portugal and Norway. Germany looked like the next and biggest domino to fall. But though Gerhard Schröder's "red-Green" coalition wobbled, it refused to topple. Just the week before Mr Schröder's victory, Sweden's Social Democrats also bucked the trend, easily winning another stint in office. Now Austria's Social Democrats have a chance of regaining power later this year. So much for Europe's inexorable move to the right.

The broader truth, however, is that on the big economic and social issues facing Europe the differences between centre-right and centre-left—between Christian democracy and social democracy—are pretty paltry. Certainly the right is still closer to business, the left to the trade unions. But the resulting differences in policy have more to do with nuance than deep philosophy. In Germany, for example, Edmund Stoiber on the right proposed a top rate of income tax of 40%, while Mr Schröder wants to bring it down to 42%. Mr Stoiber said the state should consume no more than 40% of GDP, Mr Schröder stuck to his own favourite number, 42%. Economists and businessmen may clamour for a drastic revamp of Germany's generous welfare state and for decisive moves to tackle public pensions, but neither candidate was prepared to risk suggesting anything daring. As Mr Stoiber drily remarked, he had not noticed anyone demonstrating for a radical overhaul of social security.

What is true of Germany is true of the rest of Europe. Italy's Silvio Berlusconi admires Margaret Thatcher but has done nothing to tackle Italy's pensions problem and little to free up the labour market. France's new centre-right government has moved cautiously to mitigate the worst effects of its Socialist predecessor's introduction of a 35-hour week but is committed to an extensive welfare state and shows no desire to take on the unions.

Faced with such tiny differences between left and right on the big issues of social and economic management, voters tend to plump for the most appealing personalities. One big reason why Mr Schröder and Sweden's Goran Persson won while Lionel Jospin, a French socialist, lost is that the winning pair are highly effective politicians while Mr Jospin came across as dull and stiff. Tony Blair's mastery of British politics relies at least as much on his personality—and his Schröder-like sense of what people want to hear—as on any particular policies.

It was Mr Blair who made the last real attempt to define a new pan-European (and indeed transatlantic) political *Zeitgeist*. When the centre-left held sway on both sides of the ocean, he earnestly pushed forward his big idea—"the third way". Mr Schröder tried briefly to echo him with cosy talk of a "new middle". But the whole Blairite philosophy was too vague to catch on and much of the European left disliked what little it understood of it, assuming it was code for a kind of soft-edged Thatcherism. Mr Blair has now almost given up talking about the third way. In a recent interview in *Prospect*, a British magazine, he was reduced to claiming that "in parts of Latin America [the third way] is seen as a ground-breaking moment." (They speak of little else in the queues outside Argentina's banks.)

But while a welfarist consensus may still hold sway across the European Union, consensus politics are fraying around the edges in other ways. The most striking recent trend has been the rise of populist parties openly hostile to immigration. When Austria's People's Party became the first such party to join a governing coalition, there was outrage across the EU. But the rise of politicians making similar appeals elsewhere in other EU countries has muted the outcry. The Pim Fortuyn list in the Netherlands and Umberto Bossi's Northern League in Italy have both joined governing coalitions after campaigns that

highlighted the supposedly bad effects of immigration. The new centre-right Danish government relies on the votes of an anti-immigration party. As Bertel Haarder, Denmark's immigration minister, points out, there may be a connection between addiction to welfarism and hostility to immigrants. Partly because of high minimum wages and welfare benefits, there are very few jobs for unskilled immigrants: around 60% of them in Denmark have no job. So they are easily stigmatised as free-loading parasites.

Mainstream politicians have reacted in different ways to the rise of anti-immigration parties. In France the National Front's Jean-Marie Le Pen won close to 20% of the votes in the presidential election but remains firmly beyond the pale. The new French government has nonetheless begun to toughen both rhetoric and actions against illegal immigrants. All across the EU, asylum-seekers are getting a frostier welcome.

Vox populi, a pox on civility?

The rise of anti-immigration populists has demonstrated the political potential of voicing sentiments often heard in the street but rarely in parliamentary chambers. Mr Schröder's campaign was a variation on this theme. Struggling in the polls, he decided to express the anti-Americanism that is a strong current of public opinion in Germany and the rest of the EU. Warning against “adventures” in Iraq and carping at the American economic model was just a mild version of commonplace feelings. Mr Schröder's supporters took the hint—and helped him cling on to power. However, as with the immigration debate elsewhere in Europe, once a political taboo is broken it is hard to control the consequences. German relations with America have nose-dived. And new and queasy-making sentiments are popping out of the closet at home, such as the ill-fated comparison between George Bush and Hitler allegedly made by Mr Schröder's justice minister. Sometimes taboos are there for a reason.

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Blair's government

Should try harder

Sep 26th 2002
From The Economist print edition

Guardian

A report card on the government's performance on improving public services

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HAS the government been cheating pupils taking A-level exams by encouraging examiners to downgrade marks? Has the education secretary, Estelle Morris, been interfering with the inquiry into the exam fiasco, as the head of the government's exams watchdog says she has? As *The Economist* went to press, these questions remained unanswered. But the fact that they were being asked made this week a dreadful lead-in to next week's Labour Party conference, at which the government's domestic record will come under unaccustomed scrutiny.

The party knows that Iraq is unlikely to have much bearing on the the next election. It is domestic affairs—especially the promised improvements in public services—that will matter most. And on that front, things have not been going so well.

The government has been pouring money at an accelerating rate into the public services. Spending by government departments is rising in real terms by 6% this financial year and will be 22% higher than in 1998-99. Conscious of Labour's past reputation for profligacy, Tony Blair has always sought to reassure taxpayers that this is a reform-and-spend rather than a tax-and-spend government. The avalanche of extra cash has been accompanied by a bristling array of purportedly tough targets and by commitments to open the public services to greater competitive pressure.

But for all this, not much has improved. Spending on the National Health Service in this financial year is £20 billion ($30 billion) higher than in 1998, but much of the extra money is going into higher pay. More staff, especially nurses, have been recruited, but overall productivity has fallen (see first chart). Very long waiting times (more than a year) have fallen, but the waiting list for treatment in hospitals is still over 1m patients—about the same as in 1996. “The next step, of getting waiting times below a year, is far more difficult,” says Anthony Harrison of the King's Fund, a health-policy think-tank. Performance ratings show that 47 of the trusts that run hospitals in England improved between 2000 and 2001 but 36 deteriorated. Waiting times in accident and emergency departments have got worse since Labour came to

power.

Labour has a better story to tell on education, especially in primary schools (see second chart). But the improvement began before Labour took office in 1997 and stalled after 2000. As a result, the government has failed to meet its original targets for 2002—for expected standards in maths and English to be reached by 75% and 80% of 11-year-olds. And progress in the performance of 14-year-olds has been more modest.

As education secretary, David Blunkett pledged that he would resign if the government failed to meet its targets for 11-year-olds. In his new role as home secretary, he is finding the going no easier on another public service that voters care intensely about: maintaining law and order. Total recorded crime increased at an underlying rate of 2% in 2001-02, with some violent crimes increasing faster: robbery, for instance, rose by 27%.

In all these services, Labour's preferred method of promoting improvement—the use of performance targets—increasingly prompts derision rather than respect. The government's waiting-list target for the NHS in its first term of office led some hospital managers to fiddle their figures. There is widespread mistrust of government claims of success in the war against crime. Labour's use of targets—without independent scrutiny of its performance—commands less and less credibility. The use of targetry has another disadvantage: it alienates staff. More than three-quarters of people who leave the public sector blame the regime of central control and the paperwork that it engenders, according to a recent report from the Audit Commission.

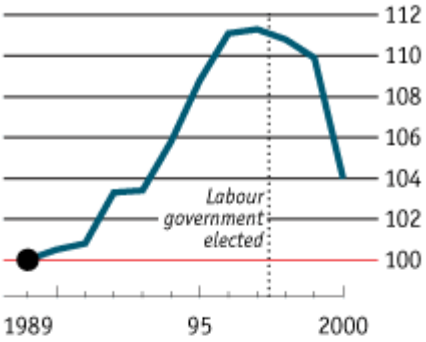
This is why Mr Blair's commitment to give private providers a bigger role in the public services was potentially so important. Unlike the managerial techniques of targets and performance management, this has the potential to ginger up the public services through real competition. But despite the prime minister's rhetoric, the private sector has been largely confined to financing and then maintaining capital projects like new hospitals. The spread of private provision into core public services like medical care or schools has been glacial. Only a handful of schools are being run as public-private partnerships.

Trade union opposition helps explain this failure. Three-fifths of public-sector employees belong to unions, compared with a fifth in the private sector. The unions fear that greater private provision will erode their power. “Labour isn't willing to take the unions on even though it clearly sees them as a massive impediment to improvement,” says Tony Travers of the London School of Economics.

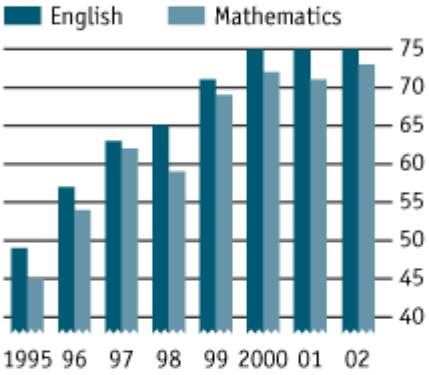
Spending without reform clearly suits the unions nicely. If higher expenditure on public services comes to be seen as payday for public-sector workers, Labour will lose the reputation for prudent economic management which it struggled so hard to win in its early, parsimonious, years.

Things can only get better...still!

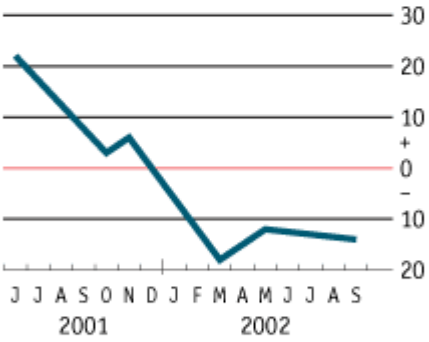
NHS productivity, measured by cost-weighted activity per unit of real resources, 1989=100



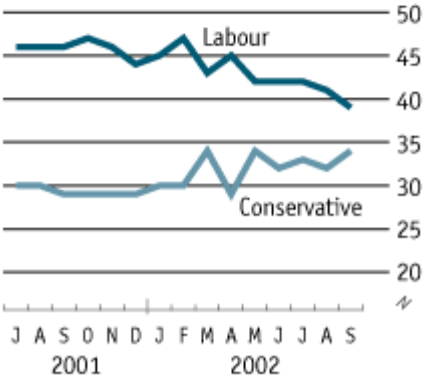
% of 11-year-olds achieving Level 4 or above in Key Stage 2 tests



Do you agree or disagree:
*In the long term, this government's policies will improve the state of Britain's public services**



Voting intention
%



*Balance of those who agree minus those who disagree

Sources: Julian Le Grand; Department for Education and Skills; MORI Social Research Institute Delivery Index; ICM

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Britain, America and Iraq

Tony's dossier

Sep 26th 2002
From The Economist print edition

What Saddam's got and what he's not

AP

Last one out turn off the gas

PRESENTING his “case against Iraq” in the form of a 50-page dossier, outlining the Baghdad regime's unconventional military ambitions, its lies to the UN and its human-rights abuses, Tony Blair got a calmer-than-expected reception in the House of Commons. Only 53 members of his own party voted against the government. It was one of the biggest backbench rebellions since Labour came to power, but Tories and Liberal Democrats abstained, and no government member wobbled.

In a well-crafted appeal to common sense which takes care not to seem hyperbolic, the dossier presents evidence that Iraq possesses and is continuing to produce both chemical and biological weapons; and that it is trying hard to acquire nuclear weapons. It says Iraq has tried to buy uranium for a nuclear weapon from an unspecified African country. In a very British attempt to be fair, the document concedes that as long as existing UN sanctions remain in place, and as long as Iraq does not manage to obtain nuclear material from some covert source, then it will not be able to produce nuclear weapons. But if it does succeed in getting fissile substances on the black market, then it could go nuclear in a year or two.

The document also made fresh allegations about the ballistic missiles which Iraq either has or wants—in defiance of UN-imposed resolutions that restrict the range of Iraqi rockets to 150 kms (94 miles). It alleges that Baghdad has illegally held on to up to 20 missiles with a range of 650 kms; has built an engine-testing facility as a step towards developing a 1,000-km rocket; and is trying to extend the reach of its short-range missiles. Non-conventional weapons, the report says, play a key part in Iraq's defence doctrine, which provides for strikes with poison gas or germs within 45 minutes of an order being issued.

“I defy anyone to say that this cruel and sadistic dictator should be allowed any possibility of getting his hands on chemical, biological or nuclear weapons,” the prime minister declared, after drawing Parliament's attention to a catalogue of Iraqi war crimes and human-rights abuses, including grisly photographs of children who died in the chemical attack on the town of Halabja in spring 1988.

Heart-rending as these pictures are, they also have some drawbacks as a presentational device, as Mr Blair discovered during the debate. Mohammad Sarwar, a Labour MP from Glasgow, challenged the prime minister to admit that Britain and America had actively supported the Iraqi regime during its worst days as a user of chemical weapons.

Wrong, Mr Blair insisted; there had been “presidential statements” from the UN Security Council rebuking Iraq. (That is true up to a point: the reason why the UN issued statements—as opposed to resolutions—is that the latter would have been vetoed by America. And both America and Britain did go on issuing trade credits to Iraq as its chemicals rained down.)

In any case, proving Saddam Hussein's wickedness was always going to be the easy part of Mr Blair's propaganda strategy. Without a miraculous change of heart in Baghdad, he will now face the harder task of arguing that a $200 billion war is the only way to disarm Iraq, and that Britain should fight in it alongside America.

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The language of war

You say potato

Sep 26th 2002
From The Economist print edition

What Britain means by regime change

IS REGIME change in Iraq the British government's policy, as it seems to be the American government's? That central question was put to the foreign secretary, Jack Straw, in the course of an interview on the BBC's *Today* programme. His answer seems to be that it is, with a crucial difference: while in America, “change” means “removal”, in Britain it means “improvement”. Here's what he said:

> If there is to be disarmament by the Iraqi regime under Saddam Hussein, then the nature of that regime will have to and will have changed quite profoundly, because its weapons of mass destruction which are the basis of the evil power which it has will have been removed.

So that's all clear, then.

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Celebrity economics

Land of hoped-for glory

Sep 26th 2002
From The Economist print edition

The media's new high-volume, low-cost product: talentless celebrities

Fame can seriously damage your looks

FAME is a funny business, and a booming one too. Last weekend Britain's most down-market and celebrity-obsessed daily newspaper, the *Daily Star*, launched a Sunday edition. On September 25th, Emap, a big magazine publisher, launched a sister magazine for its existing and highly successful weekly *Heat*, which sells around 480,000, roughly the same as its main competitors, *Hello* and *OK*!. The new rag, *Closer*, is aimed at an older audience, includes a bit more real journalism, and plans to sell around 300,000.

There are two trends here. One is that public appetite for celebrity news of all kinds is unsated. That reflects social changes such as television's dominance of leisure time, and, maybe, the breakdown of real communities and the consequent substitution of gossip about known people with gossip about unknown ones. The other shift is that manufacturers of fame are trying to make sure that they, rather than the celebrities, get the money.

That means using disposable celebrities rather than real stars. Truly talented people—actors, writers and so on—are in a sellers' market. As Hollywood studios have found, stars are demanding, and getting, an ever-bigger share of the cake.

The solution is to shift the balance between fame and talent. In the past, fame was won by achievement. Now, media companies have realised that celebrities are their main input, so they need more of them. As a result, exhibitionism alone can lead to fame, through an appearance on a television game show or reality TV. Being the relative of someone famous helps too. In a recent, particularly grotesque, British reality TV survival show, one of the leading “celebrity” participants, Christine Hamilton, was famous only for being the wife of a disgraced politician. The only talent she has displayed is for self-publicity.

Talentless celebrities are easier to manage, cheaper to produce, and much more lucrative than real stars. “Most of these people are in effect working free for the media moguls,” says Matthew Freud, one of Britain's top publicists. Reality TV draws millions of viewers. In print media, a famous face on the cover pushes up sales; so does a scandalous or salacious story. But the micro-celebrities themselves have a weak bargaining position. Most participants in “Big Brother”, Britain's first reality TV show, made less than £30,000 ($45,000) for their public humiliation, Mr Freud reckons. The current crop of reality shows crowding the autumn schedules should drive rewards down even further.

Competition from the talentless makes life tough for those a few rungs up the ladder. They can no longer rake in big fees for, say, exclusive pictures of their bathrooms. Mrs Hamilton (see above) and her husband Neil are reportedly (according to a celebrity magazine) planning a Christmas pantomime appearance. Fine for them, but tough on whichever minor soap opera actor they have displaced.

Instant celebrity is a fleeting asset because if there is no real achievement to interest the public in—no stage or screen triumphs, no interesting books, no heroic exploits—people quickly become bored. To turn celebrity into cash you have to be wily, or well-advised. Geri Halliwell, for example, a former Spice Girl, found that her solo album flopped. Her clever managers rushed out an exercise video, which sold very well. The public, it turned out, was interested in Ms Halliwell, but preferred looking at her to hearing her sing.

Some punters, of course, still drool over simple snaps of the home life of minor royalty, but the growth in the celebrity industry is elsewhere. *Heat*'s success reflects an innovative, more waspish approach, aimed at young women who might otherwise buy mainstream magazines such as *Elle*. *Closer* will mix celebrity news with real life stories (the lead story in the first issue is about an anorexic five-year-old).

So the new structure of the business is becoming clear. There is the mass-market segment: bland, commoditised, low-margin, fast turnover, and unsavourily exploitative if you look too closely. Success is about commercial muscle coupled with shamelessness. In the middle market, doing well requires a bigger dose of brains and talent. And at the top end, real stars are reaping the rewards as never before. Nice work if you can get it: most can't.

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Prince Charles

It really is appalling

Sep 26th 2002
From The Economist print edition

Writing letters is a harmless pastime. Until they are leaked

UNDEREMPLOYED celebrity seeks job as lobbyist. For more information contact charles.windsor@stjamespalace.co.uk. An advertisement along those lines would be a fitting end to this week's furore about Prince Charles's leaked letters to the government.

On the face of it, the concerns the heir to the throne raises, apparently every couple of weeks or so, about the consequences of litigation mania and bureaucracy are quite reasonable. It is absurd for a local council to cut down perfectly good horse chestnut trees for fear that pedestrians will sue if they are hit by conkers. Overly pedantic standards in care homes—where hygiene regulations, for example, prevent volunteers bringing in food for old people—are so excessive that even the government has now agreed to apply them more laxly. It is hard to imagine that the armed forces will function better if relatives of dead servicemen can sue the commanding officer.

If Britain had a proper opposition party, or a less slippery government, these questions could be aired elsewhere. Although it may be irritating for ministers to receive regular letters from the heir to the throne, it is hard to see what damage they do. If they highlight a real problem, ministers may learn something. If not, they can simply ignore them. Nobody is likely to be offended: even now, there is no strong lobby in Britain for greater bureaucracy and more litigation.

The problem comes on other questions where the prince's views are ill-informed, sentimental or downright daft. According to one leak, he complained earlier this year that the government treated farmers worse than “blacks and gays”. Although friends say he in fact mentioned only blacks in the letter, it still shows a remarkable inattention to the facts. Farmers are rarely kicked to death by skinheads. Blacks do not receive billions of pounds of public subsidy. A future king should know his subject(s) better.

A joke, sorry

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Scottish politics

SNP RIP?

Sep 26th 2002 | INVERNESS
From The Economist print edition

A small dose of independence has dulled Scots' appetites for more

Get article background

TONY BLAIR hoped that setting up a Scottish Parliament would kill off a perennial irritant to British politicians: Scottish nationalism. At the first Scottish parliamentary elections the scheme looked to have gone badly wrong—the Scottish National Party (SNP) won 35 of the 129 seats and became the main opposition to the governing Labour/Lib Dem coalition. As next May's elections loom, however, it now looks as though Mr Blair's plan may be working.

At this stage before the 1999 elections, the SNP and Labour were neck and neck in the monthly NFO System 3 Scottish opinion poll. Now Labour is ten percentage points ahead. Worse still for the Nationalists, the Lib Dems, whose votes the SNP need if they are to make a dent in Labour, are a solid five points up on their pre-1999 poll ratings. To cap that, last week the SNP lost a council seat to the Conservatives in a local by-election in Aberdeenshire, a Nationalist heartland.

This was certainly not in the SNP plan. The party thought that once the Parliament was up and running, the shortcomings of devolution—the lack of real power over taxation and such things as the railways—would become obvious. Public disillusionment with devolution, they thought, would fuel demands for real independence for Scotland.

That has not happened. The main reason is generosity from Gordon Brown at Westminster. The chancellor's spending increases mean that the Scottish government's budget is rising in real terms by about 2% a year.

A second reason was the fallout from the enforced resignation of the head of the Scottish government, Henry McLeish, in an expenses scandal last year. Voters seem to reckon that if Scottish politicians cannot be trusted with the limited powers they already have, giving them a lot more through independence is a dubious idea.

The SNP's answer is to urge voters to choose them to run a devolved Scotland, with the promise that an SNP government will hold a referendum on dissolving the union. But this downgrading of the party's central raison d'être in favour of trying to prove it can make a better job of, essentially, local government has caused internal ructions. One of its members of the Scottish Parliament has resigned and another, Margo MacDonald, a high-profile heroine from pre-devolution days, is threatening to stand next May as an independent, taking votes away from the SNP. Meanwhile party members have demoted Andrew Wilson, a bright and able parliamentary exponent of the Nationalist's new realism, in the party's candidate rankings, making his chances of re-election pretty slim.

John Swinney, who became party leader two years ago, thus had plenty of headaches this week at the party's conference, which began in Inverness on September 25th. To dampen dissent by focusing members' attention on the need for pre-election discipline, he took the unusual step of announcing the party's election slogan—“Release Our Potential”—seven months in advance of polling day. The party has also changed its colours, adding a fetching “heather” tinge to its traditional yellow and black.

“Our strategy is to prove to the people of Scotland we can make more effective use of the powers the parliament has, but that we can only make the best of our country—deal with poverty, tackle the economy—if we have the normal powers of independence,” Mr Swinney says. But if it doesn't work, plenty of SNP critics will want to release him.

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Wembley Stadium

Own goal

Sep 26th 2002
From The Economist print edition

Muddle, delay, rising costs—ah yes, the government's building something

AP

Pay up, pay up and pay the game

GIVEN the billion-pound mess the government made the last time it got involved in a big leisure venue, at the Millennium Dome, a bit of scepticism about the planned £750m new national stadium for football, rugby and athletics, seems reasonable. The score so far is dismal. Already £106m of public money (from the National Lottery) has gone on a rather murky deal to buy the Wembley Stadium site.

Since then the government's handling of the project has been marked by delay, indecision and timidity. By the standards of some of the other people involved, that looks pretty good. In May a parliamentary committee described the behaviour of English Sport, a quango in charge of overseeing the project, as “slack, slovenly and supine”.

The final details of the project, announced on September 26th, include a £426m loan from WestLB, a German (publicly guaranteed) bank, and £148m from the Football Association. Only £50m comes directly from the taxpayer. But the real costs are much higher. Britain had to withdraw its offer to host the 2005 World Athletics Championships because the government initially thought the stadium would be better as a football-only affair. That cost London millions of pounds in lost tourist revenue. Rattled by the project's delays and difficulties, the government has splurged on bankers and lawyers to nail down every detail. Fees for the pinstriped wonders are a whopping £82m.

The next big question is whether the project will be completed on time and to budget. The sad history of the Millennium Dome suggests that if it is not, even more public money will be spent to ensure that star footballers, some of the country's best paid people, have somewhere nice to play. Nobody seems to find this odd.

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Pensions

How safe is your pension?

Sep 26th 2002
From The Economist print edition

Final-salary schemes are less secure than you think

COLLAPSING share prices this year have left a trail of destruction in Britain's privately-funded pension schemes. Many companies are disclosing large fund deficits in their annual accounts. Such shortfalls are in fact notional ones as they compare today's depressed valuations of assets with present-value estimates of pension liabilities that stretch out into the future. As long as the employer remains in business the show remains on the road. But what would happen if a big employer went bust?

Surely they would be protected, most workers in a final-salary scheme—where employees receive pension benefits linked to end-of-career pay—might fondly imagine? After all, pension security was made more robust after the Maxwell scandal, when the newspaper magnate helped himself to money from pension funds that he controlled. This highlighted the more general risk of a pension-fund shortfall, which was anyway becoming a bigger worry as Britain's occupational schemes matured and more pensioners received benefits. In the 1995 Pensions Act, the government introduced the Minimum Funding Requirement (MFR), a safeguard to ensure that assets were sufficient to meet liabilities. Unlike the estimates of pension-fund assets and liabilities now shown annually in company accounts, the MFR is calculated every three years using complex actuarial rules to work out the present value of future benefits.

But 1,200 workers at ASW, a steel company that went into receivership in July, have learnt that their pensions are in peril. There is a shortfall in each of their two pension funds, even though one had a 40% surplus on the basis of its last MFR valuation two years ago. “Neither scheme will have sufficient assets to buy out all benefits in full,” says Simon Ramshaw, a director of Pinsents Trustees, an independent firm appointed to wind up the funds.

The size of the hole is not yet clear. But the Institute of Actuaries estimates that working-age members can generally expect to get only about two-thirds of their expected benefits even if the MFR valuation shows that assets in the fund exactly match liabilities. In some instances, workers can end up with even less.

So the impressive-sounding MFR does not, in fact, ensure enough money is at hand to pay all benefits if a company goes bust. When a pension fund is wound up the benefits it was offering must be bought from an insurance company, which backs them with low-risk but low-return bonds, plus extra reserves. Pension funds can rely upon the long-run higher returns from equities to make their sums add up. That expectation of such out-performance is built into the MFR calculation.

To make matters worse, the MFR rules are based on out-of-date assumptions. In particular, they have failed to keep up with the higher costs of pension annuities, driven by rising life expectancy and falling gilt yields, says Peter Thompson, chairman of the National Association of Pension Funds (NAPF). And sharp falls in stockmarkets have rendered obsolete valuations calculated as recently as a year ago.

At ASW, the losers are the current employees. This is because pensioners are top of the pecking order when a scheme is wound up. Payments to them must be honoured first, including commitments to keep up with inflation. Working-age members get what is left over. Unfair, many say. John Towill, an employee at the company's plant in Sheerness, argues that it is “quite morally indefensible that a pensioner is fully protected whereas someone who might be just months from retirement could end up with nothing.”

There will be more victims if the current business squeeze continues. Ros Altmann, a pensions specialist, is “convinced that a big scheme will wind up and people will realise they've been short-changed”. The

lack of protection for pension funds against the risk of companies becoming insolvent “is our biggest concern”, says Peter Tompkins, pensions partner at PWC, a management consultancy. “Even holiday travel agents have bonded schemes but the government has done nothing to protect pensions.”

The government is now reviewing both the MFR and the overall private-pension system. One solution would be to insure pension benefits. But that creates moral hazard: risky or dodgy behaviour by pension funds knowing that an insurer will pick up the tab. America's Pension Benefit Guaranty Corporation, a federal agency that insures final-salary pension plans, offers a salutary lesson. Founded in 1974, it was in long-term deficit for its first 22 years as claims rose far above the expected level. “The risk is that insurance would prove very expensive, and prove another reason for employers to close down their final-salary schemes,” warns Mr Thompson of Britain's NAPF.

A simpler approach would be to insist on a fairer distribution of a pension scheme's assets when it is wound up. If inflation protection for pensions in payment were made the last call on the fund, resources worth a quarter to a third of all benefits would be released, calculates Mr Tompkins. That would give working-age members more of the pie. Under existing legislation, this rejigging of pension-fund rules is due in 2007: it could be accelerated.

Greater awareness of solvency risk would be no bad thing, if it made people reconsider the merits of defined-contribution plans. These differ from final-salary schemes in that benefits must be purchased from the market value of the fund. Employers contribute less to them, so they are often regarded as an inferior pension plan. But at least there is no doubt about who owns them.

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Bagehot

Kennedy triangulates

Sep 26th 2002
From The Economist print edition

The Lib Dems have come up with an electoral strategy that could work

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IT HAS been rather a good week for Charles Kennedy. Although the recall of Parliament for a special one-day debate on Iraq interrupted the Liberal Democrats' annual conference (thankfully deflecting attention from a leisurely afternoon spent discussing the merits of allowing 16-year-olds to buy hard-core porn), the clouds of war have brought with them a silver lining for Mr Kennedy.

With Iain Duncan Smith, the Tory leader, committed to playing the role of little echo to the prime minister, Mr Kennedy has been the only party leader able to give voice to the anxiety and scepticism that opinion polls suggest is felt by much of the country. “Am I alone,” he asked, “in feeling increasingly concerned about this concept called regime change? I think not. Am I alone in worrying about the undermining of the moral, legal and practical authority of the United Nations? Again, I think not.” Mr Kennedy, whose unpompous good humour normally robs him of the gravitas to which senior politicians aspire, managed to sound serious and principled, while still leaving himself room to support future military action if sanctioned by the UN.

If that were all, Mr Kennedy could be excused for feeling quite pleased with his week's work. But he has other reasons as well. For the first time since becoming leader of the Liberal Democrats, three years ago, Mr Kennedy appears to know where he and his party should be going. This, in part, is due to his own stepped-up efforts—the “inaction man” barb had just enough truth in it to have stung—and partly as a consequence of the way in which the political landscape is beginning to shift.

Although Mr Kennedy wisely rescued his party from the blind alley of pacts with Tony Blair in which his predecessor, Paddy Ashdown, invested so much time and hope, he had put little in its place. The strategic dilemma for the Lib Dems seemed so acute that Mr Kennedy was inclined to the view that the best strategy might be to have no strategy. In recent years, the Lib Dems have prospered modestly by attacking New Labour and Blairism from the left, in particular, making the case for higher taxes to revive under-funded public services and, all too often, supporting producer lobbies, such as doctors and teachers, in their opposition to even relatively feeble government-sponsored reforms. For a party whose sentiments are firmly to the left of centre on most things and many of whose activists are involved in local government, it was easy and unchallenging.

There was even a degree of electoral logic in it. Although nearly all of the party's top 50 “target” seats are held by the Conservatives (Oliver Letwin and David Davis are both in some peril), many of those would fall to the Lib Dems if disillusioned Labour supporters in such constituencies could be persuaded to switch their vote.

But for all that, the shrewder Lib Dem tacticians (such as David Laws, a successful young banker who inherited Mr Ashdown's seat in Somerset, and Mark Oaten, the party chairman, who converted an 8,000 Tory majority in Winchester ten years ago into a 10,000 Lib Dem majority in 2001) knew that it would be impossible to take over from the Tories as the main party of opposition without a stronger, direct appeal to Conservative voters. Mr Kennedy too became convinced that heading to the left of Labour was “the biggest cul-de-sac in British politics”.

What made it easier for Mr Kennedy to give his party a shove in the right direction was Gordon Brown's opening of the public spending flood-gates. Suddenly, the notion of bidding to outspend Labour was no longer tenable. While there might be some mileage in contrasting Lib Dem frankness about the need for higher taxes with Labour's obfuscation during the election campaign, it was limited and temporary. The

one thing that everyone in British politics was able to agree on was that the issue now was delivery not money. For both the Lib Dems and the Tories everything would now depend on the expectations that the government had aroused not being met and whether they could persuade disappointed voters that they had a better way.

Mr Kennedy understood that he now had the chance to come up with a Liberal Democrat “third way” that would allow an almost perfectly symmetrical “triangulation” on both Labour and the Tories. The government, for all its talk of extra spending being “conditional on reform”, had failed to escape from a model of public-service provision based on highly centralised control of both funding and standards; and whatever the Conservatives eventually came up with would be vulnerable to the charge that behind their new enthusiasm for “localism” was a hidden agenda of privatisation and tax cuts.

Something to say, at last

This week, after many months of work behind the scenes by the grandly-named Public Services Policy Commission and a certain amount of arm-twisting, Mr Kennedy succeeded in defeating a modest but noisy grassroots revolt and getting the party conference to adopt a set of proposals that set out a reasonably coherent Liberal Democrat alternative. Its most interesting elements are: a high degree of local political accountability for devolved health and education services, under-pinned by a good deal of funding coming from locally-raised income tax; an end to centralised wage negotiations and an acceptance that local labour market conditions will influence pay; and a commitment to increase consumer choice by encouraging a wider range of service providers, including new mutual-type “public benefit organisations”, which would levy charges, but re-invest their profits.

By recent Lib Dem standards, this is pretty bold stuff. Maybe some of the ideas are impractical. It doesn't matter. What does is that on the most important domestic policy issue of the day, the Liberal Democrats now have something to say that is both distinctive and at least superficially attractive. For that, Mr Kennedy deserves some praise.

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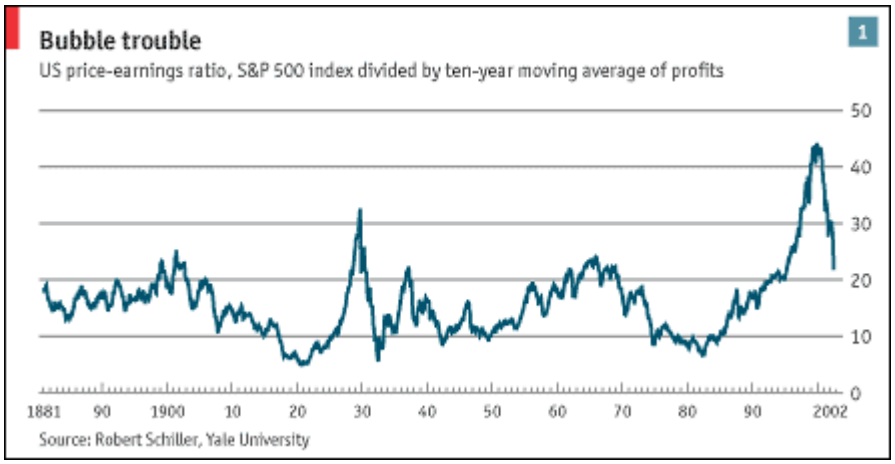
The unfinished recession

Sep 26th 2002
From The Economist print edition

Obituaries for the business cycle were premature. Indeed, economies could become more volatile again over the coming years, argues Pam Woodall, our economics editor

"IT'S only when the tide goes out that you can see who's swimming naked." This famous remark by Warren Buffett, America's best-known investor, is a perfect description of what is happening in the American economy at present. The bubble in the late 1990s masked excessive borrowing by firms and households, widespread accounting fraud and the incompetence of company bosses, but now the effects of irrational exuberance and infectious greed are being shockingly exposed. Share prices have suffered their steepest slide since the 1930s. The tide has well and truly receded.

Yet most economists are still predicting robust economic growth of 3-3.5% over the next 12 months. Many of these are the same economists who in the late 1990s dismissed the idea that America was experiencing a bubble, and who insisted only last year that the economy was not heading for a recession. They were wrong then and are likely to be wrong again. America's economic downturn is not yet over. A protracted period of slow growth—perhaps even a further slump in output—is likely to expose more financial embarrassment of the Enron and WorldCom sort.



This is no normal business cycle, but the bursting of the biggest bubble in America's history. Never before have shares become so overvalued (see chart 1). Never before have so many people owned shares. And never before has every part of the economy invested (indeed, overinvested) in a new technology with such gusto. All this makes it likely that the hangover from the binge will last longer and be more widespread than is generally expected.

Three-way split

America's mild recession last year followed its longest unbroken expansion in history. The euro area, now in its ninth year of growth, has escaped outright recession, but has seen a sharp slowdown. In contrast, Japan's economy has suffered three recessions since its own bubble burst at the beginning of the 1990s. This survey will consider what the varying fortunes of the big economies reveal about the changing nature of the business cycle.

Views about governments' ability to tame the business cycle have themselves moved in cycles. In the 1950s and 1960s it was widely believed that Keynesian demand-management policies could stabilise economies: a slight touch on the brake or the accelerator was all that was needed. But the stagflation of the 1970s produced a new economic consensus that governments were powerless to do anything except restrain inflation. The business cycle returned with a vengeance: America had three recessions between 1974 and 1982. However, since then it has enjoyed two long booms, in the 1980s and again in the 1990s, interrupted only briefly by a mild downturn, leading many to believe that recessions were a thing of the past.

The “death” of the business cycle has often been exaggerated. In the roaring 1920s, just before the Great Depression, firms and investors thought the good times would never end. In the late 1960s, after what was then the longest expansion in history, America's Department of Commerce, deeming the business cycle to be defunct, changed the name of one of its publications from *Business Cycle Developments* to *Business Conditions Digest*, only for the expansion to end a year later. Again, in the late 1990s the “new economy” was thought to be immune to the business cycle, thanks to information technology, more flexible markets and globalisation. Yet economies, like drunks, continue to move in wavy lines.

Receding recessions

The business cycle is not dead, but it does appear to have become more subdued. During the past 20 years, the American economy has been in recession less than 10% of the time. In the 90 years before the second world war, it was in recession 40% of the time. In most other economies, too, expansions have got longer and recessions shorter and shallower. The exception is Japan, which in the past decade has suffered the deepest slump in any rich economy since the 1930s.

The revolt against Keynesian policies since the 1970s was based on the belief that government intervention destabilises the economy. However, America's recent experience shows that the private sector is quite capable of destabilising things without government help. The most recent bubble was not confined to the stockmarket: instead, the whole economy became distorted. Firms overborrowed and overinvested on unrealistic expectations about future profits and the belief that the business cycle was dead. Consumers ran up huge debts and saved too little, believing that an ever rising stockmarket would boost their wealth. The boom became self-reinforcing as rising profit expectations pushed up share prices, which increased investment and consumer spending. Higher investment and a strong dollar helped to hold down inflation and hence interest rates, fuelling faster growth and higher share prices. That virtuous circle has now turned vicious.

Since March 2000 the S&P 500 index has fallen by more than 40%. Some $7 trillion has been wiped off the value of American shares, equivalent to two-thirds of annual GDP. And yet share prices still look expensive. Martin Barnes, an economist at the Bank Credit Analyst, a Canadian research firm, estimates that over the 40 years to 1995 the S&P 500 traded at an average of 15 times historic operating profits; today the ratio is 20. Moreover, experience shows that markets generally overshoot on the way down: at the trough of the previous bear market in 1982, the S&P 500 traded at only eight times profits.

For corporate America, the recession has been far from mild: profits and business investment have suffered their steepest decline since the 1930s. But despite the collapse in share prices, the economy as a whole has so far held up much better than expected. Consumer spending has remained strong, partly thanks to rising house prices that have offset some of the equity losses suffered by households. By refinancing their mortgages, households have been able to borrow more against the increased value of their homes. But debt cannot rise faster than household income forever. Eventually households will be forced to save more and spend less.

Optimists cling to the fact that growth in labour productivity remains strong, which should help firms to

restore profits as well as ensure robust long-term growth. The slide in the stockmarket, they argue, largely reflects a crisis of confidence in corporate governance and accounting fraud, not deep-seated economic problems. They need to get some spectacles.

Diminishing returns

It is true that America has benefited from faster productivity growth since the mid-1990s (although the rise is less than once thought). But as with all previous technological revolutions, from railways to electricity to cars, excess capacity and increased competition are ensuring that most of the benefits of higher productivity go to consumers and workers, in the shape of lower prices and higher real wages, rather than into profits. Equity returns are therefore likely to be a lot lower over the next decade than the preceding one.

Mr Barnes reckons that investors will be lucky to see an average real return on equities of 5%, compared with 25% in the four years to 1999. As a result, households will need to save much more towards their pensions, which will drag down growth. And if the profitability of investment in IT turns out to be significantly lower than expected, investment will remain much weaker than in the late 1990s, eroding productivity growth.

The unwinding of America's economic and financial imbalances has barely begun. Share prices are still overvalued by many measures. Companies still need to prune much more excess capacity. Most worryingly, debts still loom dangerously large. Although much of the increase in reported profits in the late 1990s was illusory, the increase in corporate debt to finance that unprofitable investment was horribly real. Dresdner Kleinwort Wasserstein, an investment bank, estimates that American corporate balance sheets are more stretched than at any time during the past half-century.

American households' net worth is likely to shrink again this year, for the third year running, after a long, uninterrupted rise since the second world war. If lower share prices cause households to increase their saving sharply, America could be pushed back into recession. Even if saving rises more gradually, the economy is headed for several years of below-trend growth. A weaker dollar would help to cushion the economy, but only by squeezing growth in other countries. The rest of the world, which benefited so handsomely from America's speculative binge, will now have to share its hangover.

American short-term interest rates are already at their lowest for 40 years. If the economy went back into recession now, the Fed would have little room to cut rates. Recession would reduce inflation from its already historically low level of around 1%, raising the risk of a deflation along Japanese lines. Falling prices would increase the real debt burden, reduce spending and so push prices even lower.

The bursting of a bubble is much riskier when inflation is low, and inflation in America today is even lower than it was in Japan in the early 1990s. Even if America escapes deflation, low inflation will mean that wages and profits grow more slowly, making it harder for firms and households to work off their debts.

Vicious cycles

Over the past decade investors, firms and consumers put far too much faith in the power of information technology, globalisation, financial liberalisation and monetary policy to reduce volatility and risk. IT, the very sector that was supposed to smooth out the business cycle through better inventory control, has ended up intensifying the current downturn.

In principle globalisation can help to stabilise economies if they are at different stages of the cycle, but the very forces of global integration are likely to synchronise economic cycles more closely, so that downturns in different countries are more likely to reinforce one another. Financial liberalisation is supposed to help households to borrow in bad times and so smooth out consumption, but again it is a two-edged sword: it also makes it easier for firms and households to take on too much debt during booms, which may exacerbate subsequent downturns.

Alan Greenspan is widely considered a highly successful chairman of the Federal Reserve, but the belief that he has special powers to eliminate the cycle is foolish. In July 2001 Mr Greenspan himself said in testimony to Congress: “Can fiscal and monetary policy acting at their optimum eliminate the business cycle? The answer, in my judgment, is no, because there is no tool to change human nature. Too often

people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the build-up or cessation of speculative excesses."

Indeed, speculative excesses in asset prices and credit flows might occur more frequently in future, thanks to the combined effects of financial liberalisation and a monetary-policy framework that concentrates on inflation but places no constraint on credit growth. The current conventional wisdom that central banks will reduce economic and financial instability by keeping inflation low and stable is flawed. Low inflation is no guarantee of economic stability.

If the Fed had increased interest rates sooner in the late 1990s, America's economy might now be in better shape. Some economists worry that it may be making a similar mistake now by allowing low interest rates to encourage a rapid increase in house prices and mortgage borrowing. The Fed may be offsetting the bursting of one bubble by inflating another.

This survey will analyse the causes of recessions, examine whether economies are becoming more or less volatile and ask what policymakers can do to prevent downturns. It will also explore the controversial idea that recessions are a necessary, sometimes even desirable feature of economic growth: they purge the excesses of the previous boom, paving the way for the next expansion.

Its two main conclusions will not make comfortable reading. They are, first, that after decades of declining economic volatility in developed economies, the business cycle is likely to become more volatile again over the coming years; and second, that America's "recession", defined as a period of growth significantly below trend (and hence accompanied by rising unemployment), is far from over. Until America's excesses have been purged, robust growth is unlikely to resume.

The job of policymakers is ideally to curb the build-up of speculative excesses. If they fail, then their task is to ensure that recessions do not become too deep, rather than try to prevent them altogether. Such efforts simply leave large economic imbalances. An economy that has been on a binge will inevitably suffer indigestion. Stuffing it with yet more credit is unlikely to aid its recovery.

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Of shocks and horrors

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From The Economist print edition

The causes of booms and busts

IN THE bible, Joseph tells the pharaoh to expect seven years of plenty followed by seven lean years. That was, perhaps, the first documented business cycle—and the first (and probably last) example of an accurate economic forecast. Recorded data on business cycles go back to the early 19th century, but economists still cannot agree about what causes contractions and expansions in economic activity.

Economists have come up with all sorts of explanations, from the effect of sunspot activity on climate to the alignment of planets and their magnetic forces. The current preference is to look for more down-to-earth causes, which come in two main varieties: those that explain the business cycle as a self-perpetuating process, and those that blame recessions on shocks or policy mistakes. The main theories are:

• **Exogenous shocks**. Recessions, it is argued, are caused by unexpected events, such as the rise in oil prices in the mid-1970s or, as some (incorrectly) tried to argue, the terrorist attacks on September 11th last year. If so, recessions are, by definition, totally unpredictable. They cannot be prevented, but once they have arrived governments can use fiscal and monetary policies to cushion demand.

• **Keynesian theory**. John Maynard Keynes blamed recessions on the inherent instability of investment caused by "animal spirits": swings in the mood of producers, from optimism to pessimism. As investment slumps, jobs and household incomes fall, amplifying the initial drop in demand. Unemployment rises because workers will not accept the pay cuts required to price the jobless back into work. So, to bring the economy back to full employment, the government needs to pursue expansionary policies.

• **Real business-cycle theory**. This theory, which emerged in the early 1980s, sees productivity shocks as the cause of economic fluctuations. For example, if productivity falls, current returns decline, says the theory, so workers and firms choose to work less and take more leisure. Rather than explaining the cycle in terms of market failure, as Keynes did, real business-cycle theory views a recession as the optimal response by households and firms to a shift in productivity. If so, there is no point in governments stimulating the economy. But most economists find this theory hard to swallow. Mike Mussa, a former chief economist at the IMF, and now at the Institute for International Economics, describes it as "the theory according to which the 1930s should be known not as the Great Depression, but the Great Vacation."

• **Policy mistakes**. The late Rudi Dornbusch, an economist at the Massachusetts Institute of Technology, once remarked: "None of the postwar expansions died of old age, they were all murdered by the Fed." Almost every recession since 1945, with the exception of last year's, was preceded by a sharp rise in inflation that forced central banks to raise interest rates. The first mistake was to allow economies to overheat; the second to slam on the brakes too hard. This theory gave rise to the popular belief that recessions could be avoided so long as governments pursued prudent monetary policies to keep inflation low and stable. Yet the recessions in Japan after the 1980s bubble and America more recently suggest that price stability does not prevent booms and busts.

• **Austrian business-cycle theory**. This is the oldest, developed by Austrian economists such as Ludwig von Mises and Friedrich Hayek in the early 20th century. Unlike Keynes, who thought recessions were caused by insufficient demand, these economists put them down to excess supply brought about by overinvestment. As a result of mutually reinforcing movements in credit, investment and profits, each boom contains the seeds of the subsequent recession and each recession the seeds of the subsequent boom.

According to Hayek, output fluctuates because the short-term interest rate for loans diverges from the "natural" or equilibrium interest rate—the rate at which the supply of saving from households equals the

demand for investment funds by firms. If central banks hold interest rates below this rate, credit and investment will rise too rapidly, and consumers will not save enough. This creates a mismatch between future output (which will increase as a result of higher investment) and future spending (which will fall as a result of lower saving today). Cheap credit and inflated profit expectations cause both overinvestment and "malinvestment" in the wrong kind of capital. The mismatch between saving and investment will eventually push up interest rates, making some previous investments unprofitable. Too much capacity will also reduce profits. Investment collapses, ushering in a recession. As excess capacity is cut, profits rise and investment eventually recovers.

According to this theory, central banks would not be able to avoid a downturn by heading off a rise in interest rates. The only way to prevent the cycle from turning is to inject ever more credit, which becomes unsustainable. A recession is inevitable, and indeed necessary to correct the imbalance between saving and investment.

A tour of the Austrian Alps

In the second half of the 20th century, self-perpetuating theories of the business cycle were almost completely ignored in favour of theories that stressed shocks or policy mistakes. Most recessions were caused largely by economies overheating, forcing central banks to raise interest rates. Now, however, the fall in inflation has brought the inherently cyclical behaviour of credit, investment and profits to the fore.

In the late 1990s inflation rose only slightly, leading most economists to believe that growth would continue in America. Only a few economists, such as John Makin, at the American Enterprise Institute, and Stephen King, at HSBC, recognised that this cycle was different: that it was an investment-led boom that carried the seeds of its own destruction.

The recent business cycles in both America and Japan displayed many "Austrian" features. Hayek argued that the natural rate of interest could rise if faster productivity growth increased expectations about profits and hence investment opportunities. This is what happened in Japan in the 1980s and in America in the 1990s. If such a shift in investment occurs, central banks need to raise interest rates. But because inflation was low (and because Austrian economics had long gone out of fashion), the Fed and the Bank of Japan failed to do so. The cost of capital therefore fell below its expected return, fuelling a surge in credit, equity prices and investment.

Investment normally accounts for about one-sixth of America's GDP, but during the three years to 2000 the investment boom pushed up its share of GDP growth to one-third. Overinvestment caused the return on capital to decline. Anybody who looked at the profits of corporate America in 2000, as reported in the national accounts (which allow for the true cost of stock options) rather than by the companies themselves, should have seen trouble coming. Profits had been falling since 1998, as before every previous recession (see chart 2). Investment will not rebound until excess capacity has been cleared and profits have improved.

Strict Austrian-school disciples would argue that because the current downturn is due to overinvestment, the Fed's repeated easing of interest rates is wrong; it delays the correction of past excesses. The present economic and financial disruption is needed to bring saving and investment back into balance. But most economists today would accept that in the face of a severe recession central banks need to act. Even the Austrian economists recognised that a collapse in confidence could push the economy into a much deeper recession than necessary. Monetary and fiscal policy therefore still has a role—not to avoid recession, but to head off a downward economic spiral.

Many economists still do not accept that this recession has been quite different from all previous post-war cycles, and that the shape of the recovery will therefore also be different. Investment-led downturns tend to last longer because it takes much more time to eliminate financial excesses than to tame inflation. High debts and excess capacity will restrain growth.

The complete rejection of Austrian-school ideas over the past half-century partly reflected a desire by economists to develop a framework that could explain all business cycles. The truth is that there is no single cause of cycles. Sometimes an oil-price shock or a policy mistake may trigger a recession, but the endogenous movements in credit, investment and profits are also always at play. Indeed, the Austrian cycle may become more common again if, as this survey will argue, financial liberalisation has made bubbles in credit and investment more likely.

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Defining the R-word

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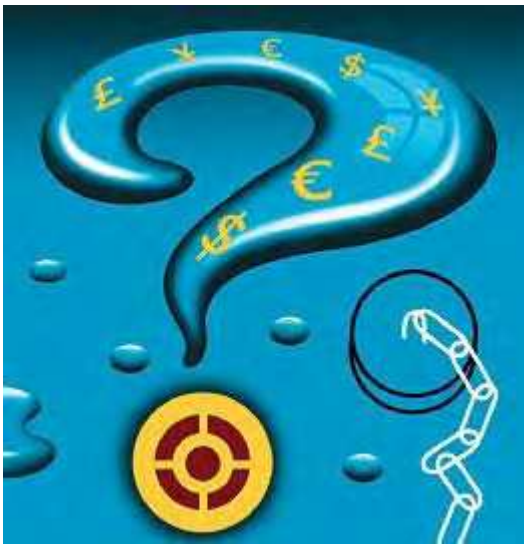
What is a recession?



WHEN your neighbour loses his job, it is called an economic slowdown. When you lose your job, it is a recession. But when an economist loses his job, it becomes a depression. This old joke probably contains a grain of truth about the way economists perceive the severity of recessions. But what, exactly, are they?

According to a popular rule of thumb, recessions are defined by at least two consecutive quarters of declining GDP. However, the National Bureau of Economic Research, America's official arbiter of recessions, takes a more sophisticated approach. A recession, it says, is "a significant decline in activity spread across the economy, lasting more than a few months, visible in industrial production, employment, real income and wholesale-retail trade." The NBER's recession-dating committee does not actually look at GDP figures, because they come out only quarterly, not monthly, and are continually revised. Last year's figures intially showed that output fell in only one quarter, but revised figures now show three consecutive quarters of decline.

The NBER defines a recession as an absolute decline in economic activity. However, some economists view it as a period when growth falls significantly below its long-term potential. This makes more sense where an economy's potential growth rate shifts over time, or when comparing economies that are growing at different speeds. Suppose country A has a potential growth rate of 4% and country B one of only 2%. A growth rate of 2% in country A will cause unemployment to rise, but in country B it will leave unemployment unchanged. By this definition, country A would be in recession.

The Japanese have long defined a recession as below-trend growth. By that definition, they suffered several recessions between 1950 and 1992 even though during that period their country's GDP fell in only one year. Their average annual growth of under 1% in the 1990s, compared with over 4% in the 1980s, makes their decade-long recession as deep, by this gauge, as in many economies during the Great Depression. The snag with this definition is that potential growth rates are devilishly hard to estimate. An easier definition of a recession is a drop in GDP per head. This would allow for the fact that America's population is rising, whereas Japan's and Europe's is flat, so slow GDP growth in America can leave the average person worse off.

The choice of measure makes a huge difference when comparing the severity of recessions. Suppose that America's potential growth rate is 3.5%, as the optimists claim, and that the economy grows by an average of less than 2% a year over the next few years, as this survey will suggest it might. If so, the total shortfall in output relative to potential over the four years to 2004 would amount to 8% of GDP, making this the worst recession since 1945.

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Keeping a lower profile

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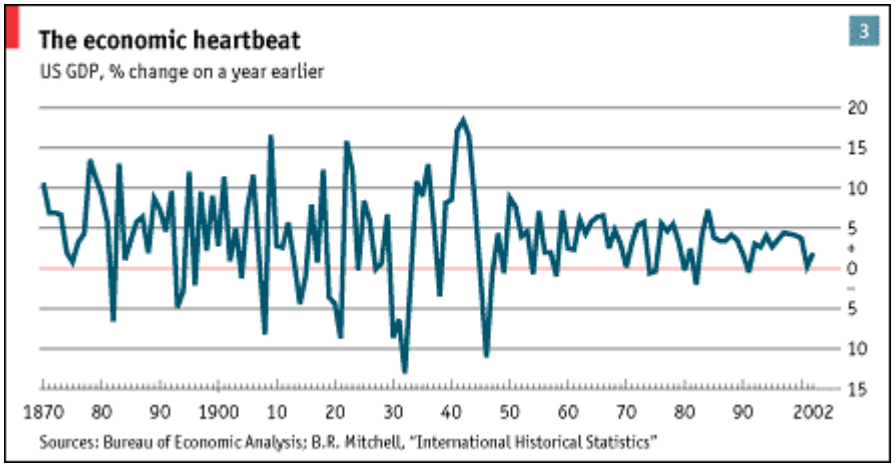
Economies have become less volatile—but they may not stay that way

ECONOMIES are much less volatile than they used to be, for all that the newspaper headlines seem to suggest otherwise. A century ago deep recessions were common; now they are rare. Why has economic activity become less bumpy?

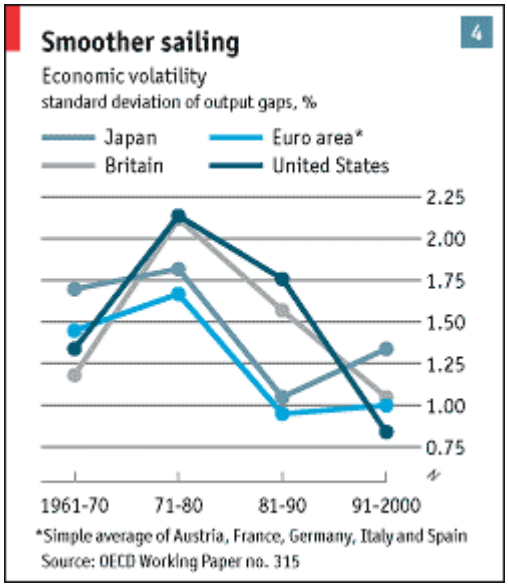


America's NBER has dated the peaks and troughs of the country's cycles back to 1854. Over the years, expansions have got longer and recessions shorter and shallower (see chart 3). An analysis by Victor Zarnowitz, an economist at America's Conference Board and one of the world's leading experts on business cycles, has found that before 1945 the American economy was in recession for two years in every five. Since the second world war, it has been in recession only about one year in six, and the average length of a recession has fallen from 21 months to 11. Since 1945 the standard deviation (a measure of volatility) of quarterly changes in GDP has been only half of what is was before 1918 and only one-third of its level in 1919-45.

Other economies have also experienced flatter cycles. An IMF study of 16 developed countries found that the average peak-to-trough decline in GDP during recessions was 4.3% in 1881-1913, 8.1% in the turbulent period between the wars but only 2.3% since 1950.

The business cycle has continued to moderate during the past half-century. In the past 20 years, America has been in recession for only 18 months (assuming the recent one ended in January). Indeed, the past decade was the economy's most stable in its history. An OECD study of 13 developed countries found that economic volatility rose in the 1970s, but has since fallen sharply everywhere. In the 1990s all the big economies were less volatile than in the 1960s—even Japan's (see chart 4).

After 1945, recessions in Japan and continental Europe seemed to disappear. Following the devastation of the war, these economies grew without pause for a couple of decades: Germany did not suffer a fall in GDP until 1967, Japan not until 1974. In general, America's economy has been more volatile than Europe's, with more frequent, though shorter, recessions.



Seeking the source

Economists have plenty of theories about why the business cycle has flattened:

• **Services**. One of the most common explanations involves the shift in output and jobs, first from agriculture to manufacturing and then from manufacturing to services. The variability of harvests makes agriculture the most volatile sector. Services, it is argued, are the least volatile. Households buy durable goods, such as cars, to use over a period of time, so if income falls such purchases can more easily be postponed than services such as haircuts.

• **Better inventory control**. Inventory investment is the smallest component of GDP, but it plays a big role at turning-points in the cycle. Over the past 50 years, changes in inventory investment have, on average, accounted for more than half of the fall in GDP during recessions. But now, thanks to information technology, up-to-the-minute information about sales and inventories and just-in-time production techniques allow firms to hold fewer stocks and to match output more closely to sales. This, it is argued, helps to prevent an unwanted build-up of stocks. American manufacturers of durable goods now hold only two-thirds as much inventory relative to sales as in the 1970s.

• **Globalisation**. Increasing international trade, the theory goes, operates as a safety valve. During a boom America, say, can tap spare capacity abroad through imports. This helps to hold down prices and so allows the economy to expand for longer without overheating. Conversely, in a recession exports help to offset weak domestic demand.

• **Bigger government**. In recessions governments, unlike firms, do not slash spending and jobs, so they help to stabilise the economy. At the start of the 20th century, public spending amounted to less than 10% of GDP in most countries. Today public spending in developed economies accounts for an average of 37% of GDP. Europe's higher public spending helps to explain why its economies have tended to be more stable than America's.

• **Automatic fiscal stabilisers**. Even more important is the counter-cyclical role played by taxes and unemployment benefits. In a recession, income taxes fall and unemployment benefits automatically rise. This helps to support incomes.

• **Discretionary fiscal policy**. Traditional Keynesians argue that since the Great Depression active measures by governments to cut taxes or increase spending have made recessions less severe. But the effectiveness of fiscal policy is debatable. The stimulus often arrives too late, fuelling tomorrow's boom rather than preventing today's recession.

• **Better monetary policy**. Until the 1930s the money supply typically shrank during recessions, partly because the gold standard denied countries any independent monetary policy. This caused deflation, and by increasing the real burden of debt deepened recessions. According to the IMF, before the second world war two-fifths of recessions were accompanied by falling consumer prices. Since then, only Japan has experienced deflation. At the other extreme, rising inflation in the 1970s exacerbated economic volatility because it forced central banks to slam on the brakes. Since the 1980s, more prudent monetary policy

has helped to stabilise output.

• **Bank reform**. Some of the worst recessions before the second world war were aggravated by banking crises. The introduction of deposit insurance, bank supervision and regulation, and a stronger lender-of-last-resort role for central banks has helped to prevent the panics that could turn recessions into depressions.

• **Financial deregulation**. The improved efficiency of financial markets in recent years has made it easier for consumers and firms to smooth their spending over time. Better access to consumer credit has allowed households to go on spending even if their incomes drop temporarily.

Taking stock

With so many reasons for greater stability, it is a wonder that the business cycle has any pulse left at all. But which of these reasons really matter? If volatility has lessened because of structural changes, such as the shift to services or new technology, then the change may be permanent. If, as others claim, milder recessions largely reflect better monetary policy, or a large dose of good luck, then the flatter cycles will persist only for as long as good policy or good luck continues.

Probably the two most important reasons why recessions have become milder since the second world war are higher government spending and hence more powerful built-in fiscal stabilisers, and measures to prevent banking crises. Neither of these is likely to be fundamentally reversed. But there is less agreement about the reasons for the decline in economic variability over more recent decades. Several of the explanations that hinge on structural changes do not stand up to scrutiny.

Take the shift from manufacturing to services. Services have increased from 39% of America's GDP in 1960 to 55% in 2001. But if the relative weight of manufacturing and services had remained constant over those 40 years, the decline in economic volatility would have been virtually the same. Many services, from telecommunications and air travel to finance and advertising, are in fact highly cyclical.

The idea that globalisation can cushion downturns is also suspect. If anything, increased global integration exacerbated the recent downturn, as most of the world slowed in unison. As American firms slashed their IT spending, they pushed East Asia into recession. Those economies, in turn, cut their imports from America, deepening the initial downturn.

Better inventory control as an explanation for reduced volatility has also lost some of its appeal. In the fourth quarter of 2001 American firms slashed their inventories by the equivalent of more than 3% of output, the biggest reduction in over 50 years. At first sight, this suggests that for all their investment in IT, firms are still not managing their inventories effectively. A study by James Kahn and Margaret McConnell, two economists at the New York Fed, concludes that during most of last year's recession firms did manage their stocks better than in previous post-war cycles, but that in the fourth quarter of last year firms were caught out by an unexpected rise in demand as consumers took advantage of free credit, so they had to run down inventories. IT allows firms to adjust output more rapidly to changes in sales, but it has not solved the problem of forecasting demand.

A study by Olivier Blanchard, at MIT, and John Simon, at the Reserve Bank of Australia, concludes that much of the dampening of the economic cycle in the big economies is due to a decline in inflation volatility (on top of the fall in inflation itself). The volatility of inflation increased in the 1970s, at the same time as output volatility, and then fell from the mid-1980s onwards as central banks were given more independence to pursue price stability. By anchoring inflationary expectations, central banks have made economies more stable. Unlike other theories, this explains why economic instability increased in the 1970s and then declined.

James Stock, at Harvard, and Mark Watson, at Princeton, agree that better monetary policy has been an important factor. They estimate that it could account for up to a quarter of the total reduction in the volatility of America's GDP in the 1990s. They rule out better inventory management as an important cause of lessened volatility. A large part of the fall in output volatility seems to be due to a fall in the volatility of sales rather than to an improved match between production and sales. Another quarter of the decline in volatility seems to be due to the fact that there were fewer external shocks, such as jumps in oil prices. But the two economists reckon that sheer luck explains as much as half of the fall in volatility in the 1990s. In other words, it cannot be relied upon to continue indefinitely.

One important element of good luck in the 1990s was that the big economies became unusually decoupled, in contrast to the 1970s and 1980s when they were more synchronised. When different economies boom together, inflation is likely to pick up sooner and so bring the expansion to a halt. But in the 1990s the big economies were mostly out of step. When America fell into recession in 1990 the economies of Japan and continental Europe remained robust, helping to cushion America's downturn. Europe was given a boost by German unification, and Japan's economy remained bubbly until 1992. Only after America's recovery was well under way did Japan and continental Europe stumble.

During America's boom, European growth was restrained by tighter fiscal policies in preparation for monetary union, and Japan stagnated. Weak overseas demand helped to hold down America's inflation, allowing its boom to continue for longer than usual. Later in the decade, the spare capacity caused by the slump in East Asia also helped to restrain inflation. But this decoupling was a fluke. If economies become more synchronised again, volatility is likely to return.

The reluctant recession

Whatever the reasons for the flatter business cycles over the past couple of decades, the mildness of America's recent recession is still surprising. Despite a stockmarket slump, the bursting of the IT investment bubble, a jump in oil prices and the tragic events of September 11th, the recession was one of the mildest on record. From peak to trough, GDP fell by only 0.6%, compared with an average decline of just over 2% in recessions since the second world war.

One possible explanation is that because America's trend rate of growth has risen, thanks to faster productivity growth, an absolute drop in output becomes less likely when the economy slows. Most economists reckon that America's potential growth rate is now 3-3.5%, compared with 2.7% in 1980-95. This means that if growth falls by three percentage points below trend the economy now simply stalls, whereas previously it would have contracted.

Monetary and fiscal easing played a big part in keeping the recession in check. Interest rates had been cut by three percentage points even before September 11th, to be followed by almost two more points afterwards—the biggest reduction in two decades. And by sheer luck, the tax cuts, planned when the economy looked stronger, turned out to be particularly well timed, as did the increase in government spending in the wake of September 11th.

Another element of luck was that America entered the recession without the over-supply of housing that has been the norm in previous downturns, because builders had underestimated the extra demand resulting from immigration. Combined with low interest rates, this has fuelled a housing boom, helping to shore up consumer spending.

The increased efficiency and resilience of financial markets also deserves some credit. American banks entered the recession with strong balance sheets. More important, the capital markets provided a ready alternative supply of credit through last year's downturn. The financial sector, it is argued, helped to insulate the economy from the financial implications of the recession by redistributing risk. A large chunk of bank lending during the boom had been bundled into securities and sold on the secondary market, shifting risk away from banks to institutions better able to bear it.

A final explanation for America's surprisingly mild recession, favoured by Alan Greenspan, is the increased flexibility of business, thanks in part to its use of IT. More nimble firms with better information are able to adjust more quickly. Flexible labour and product markets also allow economies to cope with shocks more effectively. This may explain why recessions often last longer in Europe's set-in-their-way economies. In Germany, recessions since 1960 have on average lasted almost twice as long as in the United States. Because of market rigidities, economic excesses take longer to wring out.

Economies may be less bumpy than they used to be, but until somebody invents an antidote to swings in the mood of firms, investors and consumers, cyclical fluctuations will persist. The mildness of the recent recession and the decline in economic volatility over the past decade were both partly due to luck. In a later chapter this survey will argue that the economic cycle could become more volatile as the luck of the 1990s fades, and booms and busts in asset prices occur more often. What can fiscal and monetary policy do to cushion the ride?

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Weapons of mass distraction

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Can monetary and fiscal policy eliminate the business cycle?

THE ability of macroeconomic policy to erase the business cycle has in turn been greatly over- and underestimated over the decades. The broad consensus now is that monetary and fiscal policy can moderate the ups and downs, but they will never abolish the cycle altogether.

In the 1950s and 1960s policymakers believed that by increasing government spending, trimming taxes or cutting interest rates they could avert recessions and control unemployment. But as inflation took off in the 1970s and public debt exploded, Keynesian fine-tuning went out of fashion. Policy in the 1980s and 1990s was aimed largely at reducing inflation, not stabilising output. Governments rejected active monetary and fiscal policies in favour of adherence to rules. Central banks were made independent, and many were given explicit inflation targets. Meanwhile, governments laced themselves into fiscal straitjackets. America set balanced-budget targets in the 1990s and the euro area adopted a fiscal stability pact with strict limits on government borrowing. The notable exception was Japan, which embarked on a decade of fiscal expansion.

In the past year, interest in fiscal policy has revived. The American government administered its biggest budget stimulus for two decades. In the euro area, too, there has been a vigorous debate about whether governments should stick to their medium-term fiscal targets or allow budget deficits to widen as their economies weaken. So why did governments abandon fiscal policy in the first place?

The first reason was that public debts were on an unsustainable path. But after a decade of fiscal rectitude, by 2000 budgets in most rich countries had moved close to balance, if not surplus. That allows governments to have a more flexible fiscal policy. A second reason for disenchantment with fiscal measures was a widespread conviction that they did not work. Extra government borrowing, the argument went, would push up long-term interest rates and crowd out private investment. In addition, as public debts mount up, households expect taxes to rise in future so they may save more, offsetting the stimulus—the so-called “Ricardian equivalence” effect. In practice, most studies have found that an increase in government borrowing does indeed boost demand. However, recent research suggests that fiscal policy may pack a smaller punch than it used to.

Roberto Perotti, an economist at the European University Institute in Florence, examined fiscal policy in five countries (America, Britain, Canada, Germany and Australia) and estimated the impact on GDP of discretionary fiscal-policy changes after stripping out the automatic movements in taxes and spending over the cycle. He found that the effects of fiscal policy on GDP have become much weaker in the past 20 years compared with the previous 20. Also, increases in public spending have less effect on demand in smaller economies than they do in America.

Identifying the size and impact of discretionary fiscal policy is a tricky business, so it would be unwise to place too much weight on the exact size of the fiscal impact estimated by Mr Perotti. But the evidence that fiscal policy is becoming less effective is worth bearing in mind. This does not seem to be due to a change in monetary policy. Mr Perotti finds that real interest rates increased by less in response to bigger budget deficits in the later two decades than in the first. Nor can it be explained by households saving more for fear that unsustainable public debts will force governments to raise future taxes: personal saving rates have fallen over the past two decades in most economies.

One possible explanation lies in the increased openness of economies and greater international capital mobility. This means that a larger share of any increase in spending leaks into imports, and that a fiscal stimulus may be offset by a stronger exchange rate as higher bond yields attract capital inflows. A recent IMF paper on the impact of fiscal policy during recessions in 29 countries since 1970 found that in relatively closed economies (where imports amounted to less than 20% of GDP), such as America and Japan, fiscal policy did boost output during recessions, although by less than generally assumed. But in

open economies with floating exchange rates a fiscal stimulus had little effect.

Even where fiscal policy still works, getting the timing right is tricky. In some countries, notably the United States, it can take months to get political approval. By the time a stimulus is administered, the economy may have already recovered. In contrast, interest rates can be cut without delay, and swiftly reversed if the economic outlook suddenly improves.

Discretionary budget measures are therefore usually best avoided. Built-in fiscal stabilisers may be more effective. The automatic fall in taxes and rise in jobless benefits in recessions help to support spending. An OECD study estimates that in the 1990s automatic fiscal stabilisers on average reduced cyclical fluctuations in rich economies by a quarter. In countries with large government sectors, such as Finland and Denmark, they reduced output volatility by more than half; in Japan and America, where taxes and spending are smaller relative to GDP, their effect was more modest. A study by Alan Auerbach, at the University of California, Berkeley, finds that in America fiscal stabilisers remain just as potent today as in the 1960s.

Ideally, budget deficits should be broadly balanced over the cycle, but automatic fiscal stabilisers should be allowed to take full effect. There is nothing wrong with a budget deficit in a recession, so long as it moves into surplus during the boom. In the euro area an individual country cannot cut interest rates to counteract a shock that affects only its own economy, so allowing automatic fiscal stabilisers to operate is especially important.

Europe's stability pact is too rigid. It sets a limit of 3% of GDP on budget deficits and requires budgets to be balanced in the medium term. That does not leave enough room for budget deficits to widen in a recession. Portugal broke the 3% ceiling last year and is now having to tighten its fiscal policy severely, despite weak growth. Germany also seems almost certain to bust the 3% ceiling this year.

Given the difficulty of timing a fiscal stimulus correctly, most economists agree that monetary policy is a better tool for stabilising growth. Yet how does this fit with the widely held view that central banks' prime goal should be price stability? According to Ernst Welteke, the president of the German Bundesbank, “The European Central Bank doesn't have the job of steering the economy. The best contribution monetary policy can make to growth and employment is to keep prices stable.”

Inflation isn't everything

In practice, however, central bankers do not concentrate on inflation to the exclusion of everything else. Benjamin Friedman, an economist at Harvard University, argues that although central bankers strenuously deny having any policy objective other than price stability, in practice they all take growth into account. For example, if inflation rises above target, a central bank will generally aim to reduce it gradually rather than suddenly, to avoid inflicting too much damage on growth.

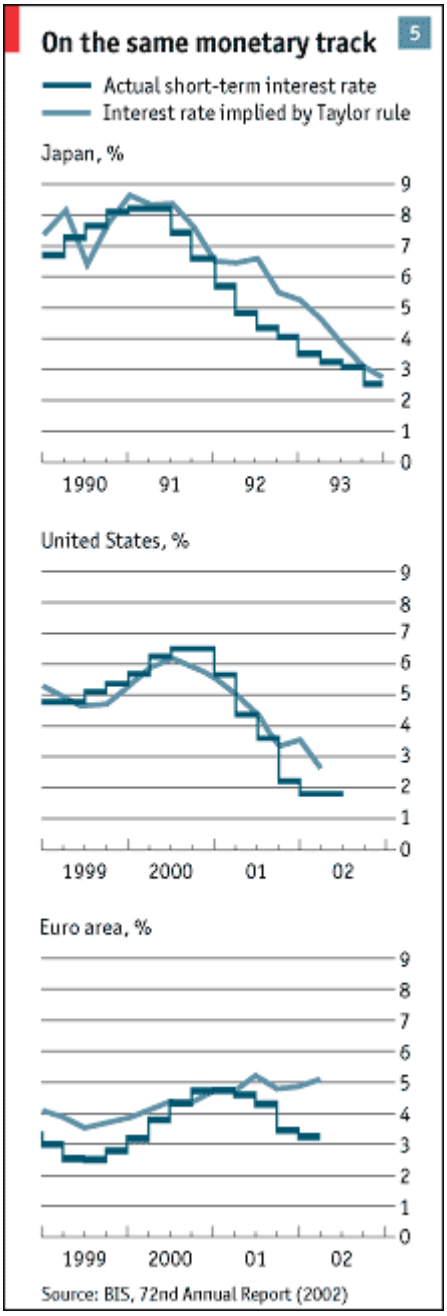
Besides, by aiming to keep inflation stable a central bank will, in effect, also stabilise output. When the economy is producing below potential, inflation will fall and the central bank will cut interest rates, helping to boost growth. When output is above potential, inflation will rise and the central bank will increase interest rates, thereby dampening down growth.

The popular perception is that America's Fed takes more account of growth than the ECB. Whereas the Fed often explains its interest-rate cuts in terms of propping up demand, the ECB always puts inflation first. Yet an analysis by the Bank for International Settlements (BIS) suggests that differences between the two central banks' policies are much exaggerated.

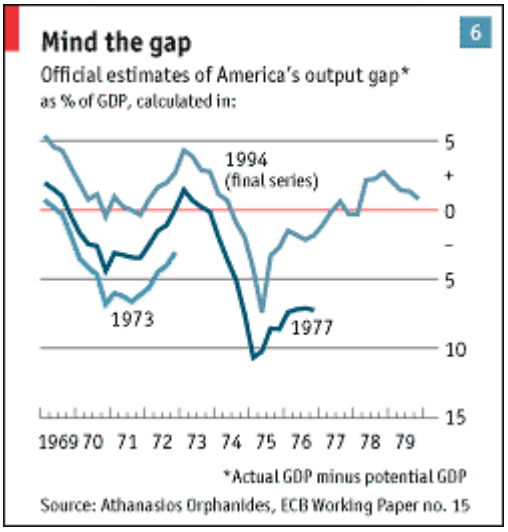
Chart 5 compares actual interest rates with those that would be required under the “Taylor rule”. Named after its inventor, John Taylor, now at America's Treasury, this offers a method of calculating the appropriate interest rate, taking into account the difference between actual and target inflation and the size of the output gap (the amount by which actual output is above or below potential output).

The chart shows that, allowing for different movements in output and inflation in each economy, the Fed and the ECB seem to set interest

rates in fairly similar ways. The ECB cut interest rates by less than the Fed last year because the economic slowdown in Europe was less severe than in America and because inflation was higher. The BIS's chart also shows that, judged by the Taylor rule, the Bank of Japan cut interest rates just as fast after Japan's bubble burst in the early 1990s as the Fed did last year.



In recent years Americans have placed excessive faith in the ability of the Fed, and particularly of Alan Greenspan, to tame the economic cycle. But monetary policy cannot be used with surgical precision. Not only are there long and variable lags before changes in interest rates affect output, but there is also much uncertainty about the potential growth rate and the size of the output gap.



Many people believe that the sharp increase in inflation in the 1970s could have been avoided if only the Fed had been using today's monetary-policy framework. But work by Athanasios Orphanides, an economist at the Fed, suggests that if the central bank had used the Taylor rule, inflation in the 1970s would have been just as high. It was not the monetary framework that caused inflation to surge, he argues, but a misperception of the size of the output gap. Official estimates of potential output at the time failed to spot the slowdown in productivity growth in the late 1960s and early 1970s. Partly as a result, monetary policy tried to stabilise output at too high a level, causing inflation to rise.

In 1973 the output gap was estimated at minus 3%, implying considerable economic slack. With the benefit of hindsight, it is now put at plus 4% for that period, implying massive upward pressure on inflation (see chart 6). With such measurement errors, a monetary policy that tries too hard to smooth the cycle could easily increase output volatility.

Too low for comfort

Nevertheless, compared with the double-digit inflation rates in the 1970s, low and less volatile inflation has helped to deliver greater economic stability. In many economies inflation is at its lowest for 40 years. Might it now be too low?

Once inflation is around 3%, squeezing it even lower will do little to improve an economy's growth performance. Indeed, as inflation approaches zero, the risks of greater economic volatility start to rise. One reason is that interest rates cannot be negative, so if inflation is close to zero there is no way to achieve the negative real interest rates that may be needed to stimulate an economy. This is the so-called “liquidity trap” into which Japan has fallen.

If real interest rates are too high, the risk of deflation increases. Deflation is much more damaging to economic stability than inflation. It deepens recessions because it increases the real burden of debt and encourages consumers to delay purchases in the hope of even lower prices later.

The lower the average inflation rate, the greater the risk of falling into the liquidity trap. Simulations by the IMF conclude that given the range of economic shocks experienced over the past 40 years, the probability of interest rates hitting zero—and hence the risk of deflation—increases markedly if average

inflation targets are set below 2%. Moreover, as inflation falls below 2%, the volatility of output starts to increase. This suggests that the mid-point of an inflation target should be set well above 2%. The Bank of England and the Reserve Bank of Australia both have mid-points of 2.5%, but the ECB's target is “less than 2%”, which is far too strict. If central banks set their inflation sights too low, warns Olivier Blanchard at MIT, at some point in the next decade another country is likely to join Japan in a liquidity trap.

That fate may yet befall the United States. Its inflation rate, measured by the GDP deflator, is currently running at only 1%. If America's recession were to resume, the Fed's ability to act would be limited.

The bank seems to be well aware of this risk. In a recent Fed study of Japanese deflation, it argues that monetary policy in Japan in the early 1990s was not too tight, given the forecasts of growth and inflation at the time, and fiscal policy was generally expansionary. However, growth and inflation forecasts consistently proved too high. At the time, nobody in Japan or abroad was predicting deflation. The Bank of Japan's big mistake was to fail to take out the necessary insurance against downside risks when its bubble had burst.

The Fed concludes that as interest rates and inflation move closer to zero and the risk of deflation rises, central banks need to cut interest rates by more than would normally be justified by prevailing economic conditions. Once deflation emerges, monetary policy can do little to pull the economy out of a slump. If, on the other hand, a central bank injects too much stimulus, it can correct this later.

Keynes argued that even when deflation has taken hold and monetary policy is “pushing on a string”, fiscal policy can still stimulate demand. Japan has tried this, running a huge budget deficit over the past decade, yet its economy remains sick and prices continue to fall. Why?

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Crystal balls-up

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“Forecasting is always difficult, especially when it is about the future”

THE dismal scientists have a dismal record in predicting recessions. In 1929 the Harvard Economic Society reassured its subscribers days after the crash that: “A severe depression is outside the range of probability.” Despite huge improvements in data and computing power, forecasters remain in the dark. In a survey in March 2001, 95% of American economists thought there would not be a recession, yet one had already started.

Why are recessions so difficult to forecast? One excuse is that economists, unlike weathermen, do not know if it is hot or cold today because their data are always out of date. They have to forecast not only the future but also the immediate past. A less good reason is that economists have a tendency to run with the pack. Predicting a recession is unpopular (especially if you work for an investment bank), and predicting one prematurely will prove costly to clients. It may also cost you your job.

Forecasts produced by economic models with hundreds of equations are notoriously bad at predicting recessions because they tend to extrapolate the recent past. This leads to big forecasting errors near turning-points, because recessions are caused by abrupt changes in the behaviour of firms and consumers. A more reliable way to spot a coming downturn is to scrutinise indicators that have given warning signals in the past. Financial indicators have the longest lead times, but a gauge that performs well in one period may do badly in another. An inverted yield curve (meaning that short-term interest rates have risen above long-term rates) has traditionally been one of the best predictors of recession. But ahead of America's 1990-91 recession the yield curve did not properly invert.

Stockmarkets are another favourite bellwether. But Paul Samuelson, a Nobel prize-winner in economics, famously quipped that the market had predicted nine of the past five recessions. In 1987, for instance, the stockmarket wrongly signalled a recession in America and Europe. Few economists believe that the recent market slide signals a further recession.

Leading indicators that combine several economic and financial measures seem more promising. The index of leading economic indicators (LEI), originally produced by America's Department of Commerce and now by the privately run Conference Board, is a weighted average of indicators such as share prices, interest-rate spreads, consumer confidence and new orders. Unfortunately, the LEI failed to predict any of the past three recessions.

The Economic Cycle Research Institute, a private research group, has been more successful. It was set up by the late Geoffrey Moore, a pioneer of research into business cycles. ECRI believes that turning-points can be systematically predicted. It tracks no fewer than 14 leading indices for different parts of the economy and with different lead times. ECRI was one of the few firms to forecast both of the past two American recessions. Its leading indicators for other economies have also fared well. It successfully forecast recessions in Japan in 1997 and 2001. Encouragingly, as this survey went to press ECRI was saying there was no risk of a double dip in America.

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Japan's lost decade

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Japan is not so much in a cycle as in a rut

Get article background

THE annual growth rate in Japan has averaged less than 1% over the past ten years, compared with over 4% in the previous decade. The OECD estimates that Japan's output gap, a measure of spare capacity, is a modest 3% of GDP, but this assumes that its potential growth rate has fallen sharply along with its actual growth. If productivity growth had remained constant at its 1980-92 average, then Japan's output gap would now be a huge 18% of GDP (see chart 7). Assuming that the truth lies somewhere in-between, Japan has suffered the deepest slump in any developed economy since the Great Depression.

Japan's policymakers, unlike America's in the 1930s, appear to have followed the Keynesian textbook: the government's budget has swung from a surplus of 2% of GDP in 1990 to a deficit of 8% of GDP. Yet the economy is still flat on its back. Is this more evidence, as argued in the previous section, that fiscal policy is becoming less effective? Some economists conclude that fiscal policy simply does not work in Japan. The government's debt of 140% of GDP is unsustainable, especially considering the future burden of a rapidly ageing population. Households know that taxes will need to rise, it is argued, so they save more, neutralising the fiscal stimulus.

Kenneth Kuttner, of the New York Fed, and Adam Posen, of the Institute for International Economics, disagree. They argue that fiscal stimuli in Japan in the past decade have been successful in boosting demand. Without them, Japan's economy would have been even weaker. However, the government's fiscal stimulus has been more modest than generally thought. The endless packages announced by the government did not contain as much new money as they appeared to. Most of the increase in the budget deficit has been caused not by public-spending increases or tax cuts, but because tax revenue has automatically shrunk as output has fallen.

Watch that output gap

Widely quoted OECD figures show a big increase in Japan's structural budget deficit during the 1990s. But if, as suggested above, Japan's output gap is really much bigger than the OECD estimates, the discretionary fiscal stimulus must have been smaller. Messrs Kuttner and Posen reckon that since 1997 fiscal policy has been causing output to contract. But in earlier years, when there were genuine tax cuts or spending increases, they did boost GDP.

Far from being ineffective in Japan, fiscal policy might actually work better there than in some other countries, because Japan is relatively closed to international trade and capital. Imports account for only 10% of GDP, the lowest proportion in any OECD country, and capital is still not fully mobile: Japanese savers remain reluctant to move their money abroad in search of higher returns. This captive pool of saving makes it easier to finance debt without pushing up interest rates.

The alarming increase in Japan's public debt has prompted talk in Tokyo about cutting government borrowing. Now is not the time. A rise in taxes would reduce growth and hence tax revenues, thereby increasing the government's deficit even further. Mr Posen argues that even now it is neither too late nor too costly for Japan to revive its economy by pursuing proper fiscal reflation, financed by the Bank of Japan buying government bonds.

But the shape of any fiscal stimulus is as important as its size. Japan's earlier packages were never designed for maximum macroeconomic effect, but often to help out politically well-connected firms. During the past decade, tax cuts have done much more to stimulate demand than increases in public spending, partly because public works were widely regarded as wasteful. This suggests that a reduction in public works accompanied by an identical cut in taxes would boost GDP.

Martin Feldstein, the president of America's NBER, suggests the use of targeted fiscal incentives. For example, the government could announce that the rate of sales tax was to be cut immediately from 5% to zero for a limited period, after which it would increase gradually to 10% once the economy was growing again. That would give consumers an incentive to buy goods now. It would, in effect, offset deflation, by creating an expectation of rising prices. The immediate revenue loss could be made up by cutting public works, and the future tax increase would put Japan's finances on a sounder path.

Demand or supply?

Some economists think this emphasis on boosting demand is misplaced. Echoing the Austrian economists, they argue that monetary and fiscal stimulus is a narcotic that prevents structural adjustments. Japan's real problem, they say, is the failure of the government to clean up the banking system. Banks keep rolling over bad loans rather than writing them off. This sustains overcapacity as unprofitable firms are kept alive, and locks resources into low-return sectors such as construction and retailing.

In a provocative paper, Robert Dugger and Angel Ubide, economists at Tudor Investments, an American fund-management company, argue that Japan is not in a “liquidity trap” but a “structural trap”, meaning that political and economic obstacles are preventing the reallocation of capital from low-return to higher-return firms. The symptoms—slow growth and deflation—are the same as those of a liquidity trap, but the condition calls for a different policy response.

In a structural trap, loose monetary and fiscal policy can exacerbate deflation and sluggish growth because unproductive but politically important firms are allowed to survive. In Japan public works have propped up inefficient construction firms; subsidies and zero interest rates help troubled firms to stay in business. By perpetuating excess capacity, this feeds deflation.

Messrs Dugger and Ubide argue that if there is strong political resistance to reallocating capital, as in Japan, monetary policy needs to be tighter than if the government were actively attacking the economy's structural rigidities. Higher interest rates, they argue, would force unprofitable firms out of business, eliminate excess capacity and release labour and capital for more productive uses.

However, raising interest rates to eliminate inefficient firms goes well beyond the mandate of any central bank. Moreover, although scrapping excess capacity would improve the return on capital and eventually help to boost growth, in the short term it would worsen deflation as unemployment rose. Much better that the government should clean up the banking sector, forcing banks to write off bad loans, which would cause unprofitable firms to close down. Monetary and fiscal policy could then be used to cushion, not prevent, the painful consequences.

Market rigidities may well blunt the effectiveness of monetary and fiscal policies. For Japan, macroeconomic stimulus and microeconomic reforms are not alternatives: they should be used to complement each other.

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A necessary evil

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Should we learn to love recessions?

WHEN America's bubble burst last year, the Fed swiftly cut interest rates. This has become a habit: every time there has been any financial turmoil at home or abroad—such as the crises in East Asia and Russia and the near-collapse of Long Term Capital Management in 1998—the Fed has pumped more money into the economy. Low interest rates have saved America from a deep recession. But after such a binge, might the economy not benefit from a cold shower?

Most people would consider this a heretical question. They assume that it is a central bank's job to avoid recessions at all cost. According to one survey, four-fifths of Americans believe that preventing recessions is as important as preventing drug abuse. But are recessions always an unmitigated disaster, or do they also offer some economic benefits? And if central banks respond to every danger sign by pumping in more money, does this not risk simply transferring the problem elsewhere? As America's stockmarket bubble has burst, another bubble now seems to be inflating in its housing market. This allows consumers to go on partying, but what happens when the drink runs out?

According to the Austrian economic paradigm described in the second section of this survey, recessions are a natural feature of an economy. Joseph Schumpeter argued that recessions are not an evil that should be avoided, but a necessary adjustment to change. Only by allowing the “winds of creative destruction” to blow freely could capital be released from dying firms to new sectors of the economy, thereby boosting future productivity.

Hayek counselled against massive monetary easing to prevent a recession. If unprofitable investments were made during a boom, then it was better to shut those firms down and clear the way for new, more productive investment. For the Austrian economists the policy choice is not between recession or no recession, but between one now or an even nastier one later. A recession is necessary to work off an imbalance between too much investment and too little saving.

Keynes, quite reasonably, ridiculed the idea that in the long run the Great Depression might turn out to have been a good thing. In the early 1930s the Fed and the American Treasury did not pursue expansionary policies, precisely because they thought these might hinder the necessary adjustment. Andrew Mellon, the secretary of the Treasury, urged the market to “liquidate labour, liquidate stocks, liquidate the farmers, and liquidate real estate...It will purge the rottenness out of the system.” America's output duly fell by 30% as the Fed sat on its hands.

Today, a slump on that scale would be unlikely even if the Fed had not cut interest rates swiftly. It would have been headed off by a variety of changes made since the Great Depression: higher government spending and hence more powerful automatic fiscal stabilisers; bank deposit insurance; and a stronger commitment by the Fed to its role of lender of last resort. But even the Austrian economists themselves

came to reject the idea that faced with a potentially severe recession, policymakers should do nothing. They approved of stimulus measures to stop recessions from turning into deep depressions, but not of preventing recessions altogether.

The case for the defence

Why is economic instability always assumed to be bad? Some economists argue that recessions result in a permanent loss of output. This rests on the notion that there is a fixed ceiling for output, rising over time, so any shortfall against potential is a permanent loss. On this view, demand-management policies can fill in the troughs without shaving off the peaks, thus increasing average growth.

A more realistic way of looking at it, however, is that business cycles are fluctuations in output above and below an equilibrium trend. This suggests that demand-management policies can mitigate recessions only to the extent that they also choke off expansions; they cannot increase the average rate of growth or employment. Admittedly, cyclical increases in unemployment may become permanent if labour-market rigidities, such as strict hiring-and-firing laws, make it hard for the jobless to find work even when the economy recovers, a condition known as hysteresis. If this is present, as it is in many European countries, then recessions can have a permanent cost. But this is really an argument for labour-market reform to minimise the cost of recessions, not one for measures to prevent them altogether.

A second argument against letting recessions rip is that households may value economic stability for its own sake, even if it makes no difference to the average unemployment rate. Justin Wolfers, an economist at Stanford University, has used surveys of consumer satisfaction from several rich economies to estimate the value that households place on stability. He reckons that starting from current levels of volatility, eliminating the business cycle would increase average well-being by the equivalent of a fall in the unemployment rate of only 0.2 percentage points. By contrast, labour-market reforms could reduce unemployment by several percentage points.

A third common claim is that economic instability and uncertainty may discourage investment, thereby reducing long-term growth. Yet the evidence is weak. More volatile economies do not appear to invest less as a share of GDP. Moreover, looking back, the 20 years to 1938 were by far the most volatile in economic history, yet the average growth rate in developed economies was 3.8%, well above the average growth of 2.7% during the past two decades of relative stability. An analysis of 20 developed economies since 1960 by Bill Martin of UBS Global Asset Management finds little evidence that macroeconomic stability promotes faster growth. If anything, he concludes, countries with greater output variability have enjoyed slightly faster growth in productivity.

This is not as odd as it sounds. A perfectly stable economy would miss out on the advantages of booms as well as the alleged disadvantages of slumps. For instance, in boom times, when credit flows freely, it is easier to finance the risky innovations that may boost future productivity growth. Booms also encourage mergers and acquisitions, a powerful tool for restructuring. More important, as Schumpeter argued, recessions are a process of creative destruction in which inefficient firms are weeded out, releasing resources for more productive firms.

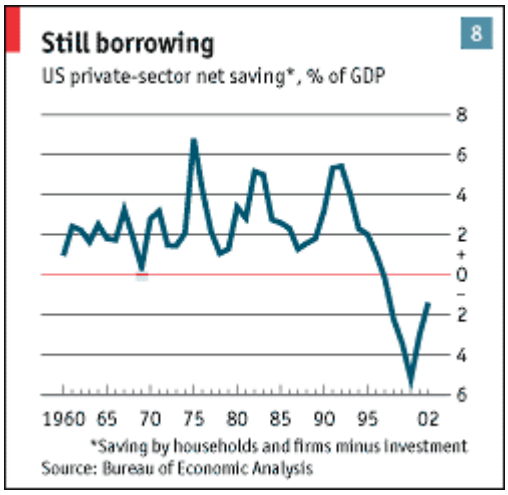
But can we be sure that it will be the least productive firms that go bust in recessions, and that they really will be replaced by new, more profitable ones? Awkwardly, work by Ricardo Caballero and Mohamad Hammour, economists respectively at MIT and DELTA, a French research organisation, finds that good times may be more conducive to economic restructuring than bad. The two economists examined gross job creation and destruction in American manufacturing over the period 1972-93 and found that at the onset of a recession job destruction increases, but it then falls below normal levels until well into the recovery. Job creation declines during a recession and remains relatively low during the initial recovery. Adding up the net effect of job destruction and creation, Messrs Caballero and Hammour conclude that the pace of restructuring actually falls during a recession.

The figures on which the study was based are available only for manufacturing, which has a shrinking share of the economy. Once services are added in, the picture might look different. Still, the study does raise the question of why recessions might hinder rather than help industrial restructuring. One answer is that credit markets are imperfect. When credit is tight in a recession, even profitable firms can find it harder to raise money to finance restructuring or new investment.

The dark side of the boom

Even if recessions are not always the most efficient way to reallocate resources, they are necessary to purge the excesses of the previous boom. Stephen King at HSBC argues that a recession should be seen as an unpleasant cleansing experience which leaves the economy in a healthier state: “A bit like taking a cold shower with a lump of carbolic soap.” But America's economy has not yet completed this cleansing process: it still has an inadequate savings rate, excessive debt and a huge current-account deficit. The recent mild recession did little to correct these imbalances, making further pain inevitable.

A good indication of the size of the adjustment yet to be made is the private sector's financial balance (or private-sector net saving, equivalent to saving minus investment), a concept elaborated by Wynne Godley, an economist at Cambridge University. In the United States the private-sector balance shifted from a surplus of 5% of GDP in 1992 to a deficit of 5% of GDP in 2000 as households and firms went on a borrowing spree, an astonishing change after almost four decades when the private sector never ran a deficit at all (see chart 8).



The corporate sector's financial position was not wildly out of line with previous periods of expansion: firms usually run a deficit during booms to finance investment. It was the behaviour of the personal sector that was exceptional, and remains so. The surge in share prices during the 1990s encouraged households to save less and less.

In the past, when a country's private-sector net saving has fallen so sharply, a deep recession or a prolonged period of stagnation has usually followed. Events in Japan, Britain and Sweden after their late 1980s booms are prime examples. Mr Godley has long argued that the same outcome is inevitable in the United States. But America's adjustment still has a long way to go. The private sector's financial deficit has narrowed to 1.4% of GDP this year, but that still leaves it well below its 1960-95 average of a surplus of 3% of GDP.

So far, most of the belt-tightening has come from firms, which have slashed their investment and laid off workers. Consumers, on the other hand, have continued to borrow, encouraged by easy money and rising house prices. But the collapse in share prices is now likely to prompt households to save more of their income. If the household saving rate rises back to its long-term norm, at the very least a period of slow growth, and perhaps another recession, will surely follow.

Was it a mistake for the Fed to slash interest rates last year and thereby delay this adjustment by households? Some economists believe that a deep but short recession is preferable to a prolonged period of sluggish growth, because recovery comes much sooner, with less damage to the economy's potential growth rate. However, it is arguably better to unwind imbalances gradually to avoid the risk of severe financial problems. Moreover, the Fed has been worried that a deeper recession at a time when inflation is already so low might lead to debt deflation, which central banks should avoid like the plague.

Lower interest rates have helped to prop up spending in America largely by fuelling a credit-driven boom in house prices. This fixes one problem at the risk of creating another. Rather than injecting more liquidity, would it not be better if central banks tried to smooth the path of credit over the whole business cycle?

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Bubble and squeak

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Central banks need to keep a closer eye on credit and asset prices

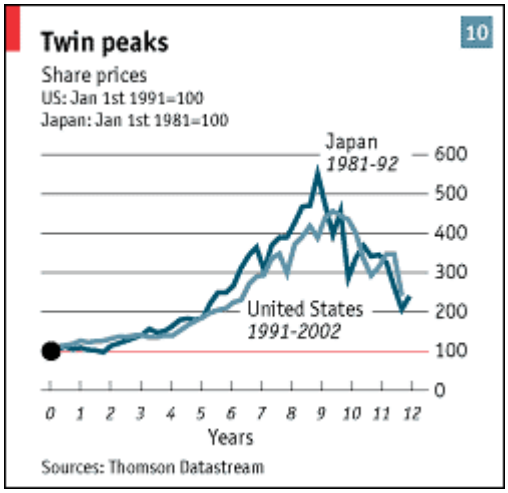
AMERICA'S current economic woes—from the collapse in share prices to the surge in bankruptcies—can all be traced back to the biggest credit boom in its financial history. Private-sector credit surged at an unprecedented pace in the late 1990s (see chart 9). Without easy credit the stockmarket bubble could not have been sustained for so long, nor would its bursting have had such serious consequences. And unless central bankers learn their lesson, it will happen again.

Central banks' main task over the past two decades has been to defeat inflation. But now they face an even tougher challenge: preventing ever bigger booms and busts in economic activity caused by increasingly large swings in asset prices and credit. Low and stable inflation was supposed to promote financial stability, yet greater stability in inflation and output has not been reflected in greater asset-price stability. Instead, the prices of assets, such as shares and property, have been subject to bigger swings over the past two decades. It now seems clear that low inflation does not guarantee financial stability. The three biggest bubbles this century—America's in the 1920s and 1990s and Japan's in the 1980s—all developed when inflation was low.

Indeed, low inflation may even encourage a build-up of financial imbalances. It can heighten the excessive optimism that helps to fuel unsustainable booms in credit and asset prices. If people believe that central banks are fully committed to price stability, inflation will be held down even as demand pressures mount, removing the need to raise interest rates sharply. That encourages a bigger build-up of debt and higher share prices as firms and households come to believe that the expansion will continue indefinitely—as they did in America in the 1990s.

A paper by Claudio Borio and Philip Lowe, economists at the BIS, suggests that a useful way of gauging the vulnerability of a monetary regime to financial instability is to consider its “elasticity”: its potential to allow financial imbalances to build up unchecked during a boom. Compared with the early part of the 20th century, today's financial regulation and supervision helps to curb banks' ability to lend recklessly. On the other hand, the external constraint on credit imposed by the gold standard has gone. Central banks now virtually ignore the pace of credit expansion so long as inflation is under control. As a result, the “elasticity” of private credit creation has increased significantly.

Until the 1980s, in most economies the growth of credit was constrained in some way. After the gold standard collapsed, this discipline had been provided by tightly regulated financial markets. Most countries had some sort of credit controls that restrained the financial cycle, but at a severe cost to resource allocation. Since then governments have set their financial systems free. In the 1980s money-supply targets helped to curb credit, but these, too, were abandoned as the various measures of money sent out confusing signals.



Messrs Borio and Lowe argue that today's combination of a liberalised financial system, a money standard with no exogenous anchor such as gold, and a monetary policy focused only on short-term inflation increases the risk of longer and bigger build-ups in credit. That makes asset-price and debt bubbles more likely.

Swings in credit growth and asset prices have always played an important part in business cycles, but their role seems to have increased of late. Financial deregulation and innovation have increased the scope for more pronounced financial cycles which, in turn, can amplify the business cycle. For instance, rather than holding loans on their books, banks now bundle loans into securities and sell them on the secondary market. The resulting stream of liquidity allowed the banking system to lend more during the boom. New financial instruments and greater competition in the mortgage market have made it easier for households to borrow.

The increase in debt since financial liberalisation is not necessarily a bad thing: savings are better channelled to borrowers with profitable investment opportunities than lying idle under the mattress. However, easier access to credit can encourage overborrowing, which leaves the economy more vulnerable to a recession. Over the past decade the deepest downturns have tended to be in countries that had previously seen big increases in debt. Now it is America's turn.

Cycles in credit and asset prices usually occur in tandem, reinforcing one another. Rising asset prices boost growth and make it easier to borrow by raising the value of collateral. Faster growth in credit and output then feeds back into higher asset prices. When asset prices fall, the process goes into reverse. More households now own houses and shares, so swings in asset prices have a bigger effect on the economy.

Riding the risk cycle

In its 2001 annual report the BIS argued that the financial system tends to be too pro-cyclical because of a misperception by banks and markets about how risk moves over the cycle. Lenders tend to underestimate risk during booms, when collateral values are rising and profits are strong. They reduce their lending spreads and loan provisions, and extend too much credit. In recessions, lenders' perception of risk rises too late as borrowers default, so they tighten their lending standards and raise provisions. All this amplifies the business cycle, extending booms and increasing the depth or length of downturns.

Some economists worry that the new Basel Accord on banks' capital standards could make things worse. From 2006 banks will have to adjust their minimum capital requirements over time, in line with changes in measured risk. The danger is that banks' internal risk assessment will vary more than it should over the course of the cycle, leading to undesirable reductions in capital cushions during booms and increases during recessions. That would make the financial system even more pro-cyclical than at present.

Should central banks try to curb unsustainable credit and asset-price booms? The usual answer is that policymakers are unlikely to make better judgments about risk and sustainability than does the private sector. But as Keynes once wrote, “A ‘sound' banker, alas!, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way, along with his fellows, so no one can really blame him.” Central bankers are less likely to run with the herd. They have longer time horizons and different incentives, as well as a better understanding of the feedback between the financial sector and the real economy, so they may respond differently to the same information.

One policy option is for capital requirements to be increased during a boom if supervisors see a potential increase in risk. Or, to cool a housing boom, regulators could restrict the maximum mortgage as a percentage of a property's value. But it would be tricky to identify exactly when this should be done. If regulators got it wrong, they might undermine the efficiency of the banking system.

The alternative is to raise interest rates to check an unsustainable rise in credit and asset prices. However, not only is it difficult to identify financial imbalances early enough to act, but central banks do not have a mandate to prick bubbles. They already do take account of rises in share or house prices to the extent that these feed into higher spending and hence future inflation, but asset-price and debt bubbles can build up with little immediate effect on inflation. Higher interest rates would be hard to explain to the public if today's inflation were well under control.

Moreover, there are doubts about the effectiveness of higher interest rates in containing share prices. Interest rates are more like a blunderbuss than a laser-guided weapon. A small rise in rates might be counterproductive if it increased confidence in the central bank's anti-inflation commitment and so boosted asset prices further. A big rate rise would probably work, but it might lead to a deep recession.

Because of these uncertainties, most central bankers believe they should not raise interest rates to stop a boom in asset prices and credit, but wait to see if the asset-price bubble bursts and then respond to

the adverse consequences. That is what the Fed did last year. But prevention is surely better than cure. The BIS concludes that although caution is required in tightening monetary policy or adjusting supervisory instruments, this should not rule out the occasional use of such policies when serious financial imbalances threaten economic and financial stability.

“Identifying a bubble in the process of inflating may be among the most formidable challenges confronting a central bank,” said Alan Greenspan in 1999. It is impossible to determine a share's fundamental value, so, it is commonly argued, central banks should ignore asset-price booms other than where they have a direct effect on inflation.

But the emphasis on asset prices alone is wrong. It is when a boom in asset prices is combined with a big increase in debt that it becomes really dangerous, because when house prices or share prices fall, borrowers get squeezed. There is therefore a stronger case for tighter monetary policy when a surge in asset prices goes hand in hand with rapid credit growth. In their study, Messrs Borio and Lowe, looking only at information available to policymakers at the time, concluded that a simultaneous explosion in both credit and asset prices usually provided a useful warning of financial problems ahead.

The argument that central banks should act only when they are absolutely certain that they are dealing with a bubble does not stand up. Central banks have to deal with uncertainty all of the time. For example, the uncertainties over the size of the output gap are also large. The real issue is whether central bankers are prepared to start arguing the case for raising interest rates in response to serious financial imbalances, and whether they are prepared to live with unpopularity if they burst a bubble in equities or house prices. Mr Greenspan would not be so revered today if he had intentionally pricked America's stockmarket bubble.

With hindsight, the Fed should have raised interest rates much sooner in the late 1990s. Its failure to do so is an understandable mistake, because with inflation so low it would have come under political attack. Less forgivable was Mr Greenspan's irrationally exuberant endorsement of the “new economy”, which contributed to the euphoria. Productivity growth has increased, but an official at another central bank argues that it would have been wiser if he had remained more agnostic, rather than acting like a fireman-turned-arsonist.

Views about how the economy works and what role monetary policy should play have changed many times in recent decades. From the 1950s to the 1970s the main objective of monetary policy was full employment. Once inflation took off, governments abandoned full employment to make the control of inflation their number one priority. Persuading the public that credit and asset-price bubbles are just as bad for them as inflation is surely no harder than making the switch from fighting unemployment to fighting inflation.

During the past century, every monetary rule has broken down in the face of changing economic circumstances: the gold standard, the Bretton Woods system of fixed exchange rates, and monetary targeting. Now it seems that strict inflation targeting is not the promised panacea either. Central bankers' fixation on short-term price stability can blind them to other important signs of financial imbalance. In turn, those imbalances can cause deeper recessions and even a future risk of deflation. Without some redesign of monetary policy to take more account of swings in credit and asset prices, economic booms and busts could well become more disruptive in future.

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United we fall

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From The Economist print edition

Increasing globalisation could lead to bigger economic booms and busts

WHEN America sneezes, the rest of the world catches cold, and last year the effect of America's downturn on the rest of world seemed more brutal than usual. As America went into recession, the euro area's economies ground to a halt, Japan's slump deepened, and emerging economies from Mexico and Argentina to Singapore and Taiwan suffered deep recessions. Does global economic integration mean that business cycles now move more closely in step?

Economies have often been hit simultaneously by common global shocks, such as the jump in oil prices in the 1970s. However, during most of the 1990s business cycles were unusually desynchronised because of shocks that affected only particular countries. When the American economy stumbled in 1990, German unification kept continental Europe aloft until 1993, and Japan, buoyed by rising land prices, continued to boom until 1992.

In contrast, last year's global downturn was unusually synchronised. According to J.P. Morgan, an American bank, the dispersion of growth rates across 41 economies fell to its lowest level in at least 30 years (see chart 11). Some of this was due to common factors, such as the bursting of the IT bubble and higher oil prices. But it seems that different economies' business cycles are also becoming more closely correlated over time, possibly because of greater economic integration.

It used to be argued that increasing trade would stabilise GDP. In a recession, exports could offset the slump in domestic demand; in a boom, spare overseas capacity would help to hold down inflation. But increased trade also causes economies to move more closely in step. Last year an investment slump in America spread quickly to Asia as American firms imported less IT equipment. In turn, Asian economies bought less from the United States and elsewhere, which depressed growth further. Greater synchronisation is likely to exacerbate the business cycle.

World trade now accounts for 25% of GDP, double its share in 1970. However, trade figures understate the degree of international interdependence. Foreign direct investment, cross-border mergers and financial markets have an even bigger effect.

A recent OECD study explored the growing internationalisation of production through global supply chains. Multinational firms base different parts of their operations in different economies to make use of comparative advantages, such as cheap or highly skilled labour. Foreign direct investment has increased the importance of international trade within firms. One-third of both America's and Japan's total trade takes place within multinationals and their affiliates. The share of intra-firm trade is especially high in the IT sector, which is why the IT investment bust spread so rapidly around the world. The OECD concludes that thanks to the internationalisation of production, a demand shock in one country will have wider international effects than in the past.

For many multinational firms, foreign direct investment has also become a substitute for trade. For example, a German car maker will produce locally in America rather than exporting there. European firms' dollar sales from their American subsidiaries are now four times bigger than their exports to America. The slump in America last year squeezed such parent firms' profits, prompting some cutbacks in Europe. American multinationals also responded to the slump at home by cutting back at their European subsidiaries.

It's the same the whole world over

Financial markets are another important channel for transmitting shocks across borders. Stockmarkets in Europe have fallen by just as much as Wall Street over the past two years. William Goetzmann, an economist at Yale School of Management, calculates that in recent years the correlation between the markets of America, Britain, France and Germany has been closer than at any time in the past century (see chart 12). The cost of capital for European firms may therefore be more sensitive to ups and downs in America than in the past. A collapse of share prices on Wall Street will also have a bigger effect on wealth and spending all around the globe.

There are many reasons why share prices are dancing to the same beat. Cross-border trading in shares has increased hugely over the past decade, creating a global equity market. In most rich countries, household are increasingly investing in foreign equities. Many big firms are also listed on more than one stockmarket. And thanks to cross-border mergers and foreign direct investment, a growing slice of firms' profits comes from abroad.

Is the recent close-coupling of national stockmarkets a temporary phenomenon, caused by the IT bubble and the consequent global slowdown, or does it reflect the growing international integration of firms? Robin Brooks, an economist at the IMF, and Marco Del Negro, at the Federal Reserve Bank of Atlanta, tried to discover whether the increased correlation of stockmarkets can be explained by firms becoming more global, as measured by the percentage of their sales and profits that are generated abroad. They analysed company accounts and share prices for 10,000 firms in 42 markets over the period 1985-2002, and found that such global factors had indeed become more important in explaining variations in companies' profits in the late 1990s. Global factors were especially important in explaining the relative share prices of firms that derive a high proportion of their profits from overseas. This suggests that the rise in stockmarket correlations in the late 1990s may indeed reflect global integration. If so, it is likely to increase further over time.

Another way in which recession can spread from country to country is through business confidence. The IMF finds that there has been a substantial increase in the correlation between business confidence in America and the euro area in recent years. This probably reflects the stronger links between firms in America and the euro area through mergers, as well as the effect of global share prices on business confidence. Either way, the mood of businessmen can be a lethal form of contagion.

As economic and financial interdependence continue to increase, developments in one economic area will affect other economies more than in the past. As a result, global business cycles are likely to become self-reinforcing, which could make booms and recessions in developed economies more severe.

Policymakers clearly need to take more account of what is happening in other countries. Traditional economic models that look only at trade will understate the effect of a shock in America on other economies. Foreign investment, share prices and confidence are likely to be far more important. The ECB was caught out last year when it underestimated the impact of America's downturn on the euro area. Even though Europe did not suffer from the sort of imbalances seen across the Atlantic, its economies stumbled as falling equity markets hurt business confidence.

Does growing economic interdependence increase the case for international policy co-ordination? In the past, attempts at this by the G7 group of rich countries have had unhappy consequences. At the Bonn summit in 1978, Germany agreed to reflate and act as the world's locomotive. But oil prices then surged, triggering a burst of inflation. In the late 1980s, at the Louvre meeting, Japan agreed, under pressure, to ease its monetary policy in return for America cutting its budget deficit. Many now regard this as a prime cause of Japan's financial bubble.

The regular exchange of information and frank discussion about policy in each other's economies is useful. But, wisely, the G7 have avoided formal agreements to co-ordinate policy in recent years. The best global economic policy is the sum of the best national policies that take account of developments elsewhere.

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After the bubbles

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Brace yourself for a bumpier time ahead

DESPITE the slump in share prices, most economists reckon that America's economy will continue to recover this year. They believe that the post-bubble recession was mild thanks to the Fed's superb monetary policy and the American economy's amazing flexibility. In reality, though, America's first recession of the 21st century may not be over.

The optimists base their forecasts on their belief that America's economy is “fundamentally sound”—or as sound as an economy can be with inadequate saving, far too much debt and a massive current-account deficit. America not only had a stockmarket bubble in the late 1990s, it experienced a wider economic bubble that distorted decision-making across its whole economy. This created excesses that need to be purged before the economy can return to vigorous and sustainable growth.

Firms have made great strides to cut costs and capacity, yet corporate debts still look uncomfortably large, so further pruning is likely. Troublingly, consumers have continued to borrow as if little has changed. By slashing interest rates, the Fed has encouraged a house-price boom that has partially offset equity losses and allowed households to take out bigger mortgages to prop up their spending. But for how long? House prices are high in relation to income, so the room for further gains is limited. Households' debt-service payments are also close to a record high, even though interest rates are low.

Households cannot keep borrowing at their current pace. At some stage they will need to start saving more and spending less. If this happens abruptly, it will trigger another, deeper recession. If instead the adjustment is made gradually, America could face several years of sluggish growth of less than 2%. That would be well below the economy's trend growth rate, so unemployment would rise. In this sense, America's “recession” is far from over.

Could America follow Japan into a decade of stagnation? The popular perception is that America's economy has held up much better than Japan's did after its own stockmarket bubble burst in December 1989. Yet America's economy now looks awfully like Japan's in the early 1990s, when Japanese investment fell but consumer spending and productivity growth remained robust for a couple of years. Deflation did not appear until 1995. America may yet face further troubles.

There are, of course, big differences between the two economies. Market forces work better in America's more flexible and competitive economy, so excess capacity is likely to be scrapped and capital reallocated more speedily than in Japan. America's economy is also much less dependent on banks than Japan's, relying more on capital markets as a source of finance for firms. Capital markets, unlike banks, re-price assets immediately instead of deferring the pain. Japan's sick banks have also been unable to make new

loans, which has delayed recovery. American banks are in much better shape.

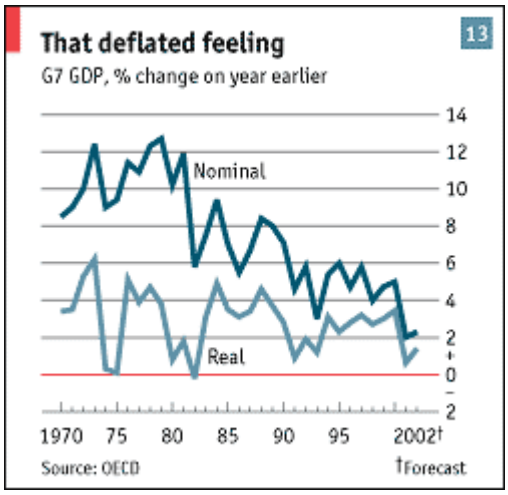
A third point in America's favour is that its political system is less rigid than Japan's. If politicians fail to deliver economic recovery, in due course they will be replaced. In Japan the LDP is still in power, despite a decade of near-stagnation. The result is policy paralysis.

Nevertheless, American policymakers cannot afford to be complacent. The list of differences between Japan and America has got shorter over the past year. America, it used to be argued, had better corporate governance and more accurate financial accounts than Japan. Enron and WorldCom have exposed that myth. America, it was said, had only a stockmarket bubble, whereas Japan also had a property bubble. The rapid growth in house prices and mortgages in America over the past couple of years is starting to look suspiciously bubble-like.

Last, but not least, America supposedly had plenty of room to cut interest rates, so it could avoid deflation. But by now the Fed has shot most of its ammunition: with interest rates and inflation already so low, there is little room for further easing if the economy stumbles. That raises the spectre of falling prices, which would be devastating in an economy so awash with debt.

Some Europeans may be tempted to gloat over America's misfortunes. But if America sinks back into recession, it will take much of the rest of the world with it. As America's current-account deficit becomes harder to finance, a sharp fall in the dollar will export deflationary pressures to other countries. Worse, policymakers in Japan and the euro area currently seem unwilling or unable to offset such a shock.

Measured by real GDP, last year's global recession was relatively mild, but nominal GDP growth in the G7 economies fell to its slowest rate for decades (see chart 13). In this year's “recovery”, nominal GDP growth is running at just over 2%, less than the typical rate seen during other recessions since the second world war. In this sort of environment, it becomes much harder for firms to increase their profits and work off their debts. Most companies, investors, households and policymakers have never experienced anything like it during their lifetime.



A false sense of security

Current wobbles aside, most analysts still assume that the greater economic stability of recent decades will continue. They hope that IT will allow firms to go even further in eliminating the inventory cycle, and that sound monetary policies will continue to prevent the high inflation rates that caused economic instability in the 1970s. That would have important implications. A more stable economy is a less risky economy, which would justify a lower equity-risk premium. Historical price-earnings ratios would then be irrelevant, so share prices might now be undervalued. And if incomes and profits fluctuate less over the cycle, then households' and firms' current large debts might prove perfectly manageable.

However, this survey has identified several factors that might make the economic cycle more rather than less volatile over the coming years, thus prompting investors to demand a higher risk premium. One consideration is that America's enhanced economic stability in the 1990s was in large part due to luck, such as the unusually desynchronised nature of business cycles in the main economies. This helped to curb the usual inflationary pressures during America's boom, allowing it to continue for longer. In future, as economies become more internationally integrated, economic cycles are likely to move much more closely in step. If everybody sinks together, recessions could be deeper.

A second cause for concern is that fiscal policy may be less able to cushion downturns than in the past. There is some tentative evidence that fiscal policy is becoming less potent as economies become more open. More worrying, in some circumstances monetary policy may also prove to be a blunter weapon. If central banks try to hold inflation too low over the cycle, they will leave themselves too little room to ease policy in a deep recession, because it will be harder to deliver negative real interest rates. In the next cycle inflation and interest rates could peak at a lower level than in the last one, and as inflation

gets closer to zero economies become more unstable, as Japan has discovered. This is not to argue for a return to double-digit inflation, but to suggest that central banks should aim to keep inflation above 2%.

Even then, low inflation can amplify the business cycle in another way. In the 1970s and 1980s high rates of inflation allowed inflated asset prices to adjust back to their fair values without the need for a big drop in nominal prices. For instance, British property prices in the four years to 1993 fell by 25% in real terms, but by only 8% in nominal terms. If today's boom in house prices around the globe does turn out to be a bubble, then with such low inflation house prices would need to fall more sharply in absolute terms to bring the market back into balance. That would be painful for those with big mortgages.

In a world of low inflation, excessive swings in asset values are therefore even more dangerous. Yet this survey has argued that financial liberalisation, combined with central banks' single-minded emphasis on inflation, has increased the risk of asset-price and credit bubbles. Japan in the 1980s and America in the 1990s could be just the first of many.

Moreover, equity and property prices are not only likely to be more volatile, they will also have a bigger effect on consumer spending than they used to. As people live longer after retirement and the average age of populations increases, more people will be dependent on the value of their assets, in the shape of both property and equities, rather than income from employment.

After a period of relative calm, the business cycle is likely to become bumpier again. What does this mean for policymakers? Until recently, central banks believed that so long as inflation was kept firmly under control, booms and busts could be avoided. Yet in reality low inflation does not guarantee stable growth. If central banks are to prevent bigger booms and busts in future, they need to take a broader view and sometimes act to curb excessive growth in debt and asset prices.

A second lesson is that governments need to do more to enable economies to cope with volatility. Flexible markets, stronger financial institutions and better corporate governance can help to minimise the cost of recessions. If Japan and the euro area were to press ahead with reforms, it might also help to boost their domestic growth, reduce their dependence on America, and so partly offset the growing synchronisation of economies.

The third and most important point to remember is that the business cycle will never be eliminated; it is part of human nature. Indeed, once people think that the cycle has become a thing of the past, they act in ways that sow the seeds of the next recession. If central banks succeed in postponing a recession, they will simply encourage more reckless behaviour, making the next downturn worse. A recession once in a while may actually be a good thing, as long as it is not too deep. It reminds companies, households and investors of that other R-word: risk.

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Sources and acknowledgments

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Sep 26th 2002
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Mobile telecoms

Time for plan B

Sep 26th 2002
From The Economist print edition

A technological escape-hatch exists for Europe's troubled mobile operators. But they are not allowed to use it

Get article background

AT LAST, some good news for Europe's ailing wireless industry: Mobilkom, an Austrian operator, this week launched its third-generation (3G) service. 3G is faster than existing 2G technology, with the potential to offer whizzy new services such as sending video by phone. Hutchison 3G will launch in Britain next week. Is the 3G bandwagon finally starting to roll?

Well, not quite. In both cases, handsets are in very short supply. Sonera, Finland's national operator, was due to stage its 3G launch on September 26th, but postponed it until next year due to handset shortages. How embarrassing for Sonera, and for Nokia, the world's largest handset maker. The fact that the two firms cannot get 3G to work in their wireless-crazy Finnish homeland does not bode well.

Why the delay? European operators must, under the terms of their 3G licences (for which they paid over *euro*100 billion, or $90 billion), provide 3G service by particular deadlines, and do so using a technology known as W-CDMA (never mind what the letters stand for). Alas, W-CDMA does not work yet. Handsets made by one firm do not work properly with network equipment made by another, says Björn Krylander of UbiNetics, an equipment-testing company. Since operators prefer to use equipment from more than one supplier, 3G can only take off when this problem is solved, which could take a while. 3G seems unlikely to become widespread in Europe until 2004 at the earliest—and it will be several years before it turns a profit.

These technical problems, and the resulting delays, have far-reaching consequences. A number of European operators are backing out of their 3G commitments or trying to win concessions from regulators. In July, Sonera abandoned a *euro*9 billion joint venture with Telefonica Moviles, a Spanish operator, to launch 3G services in Germany. Orange, a multinational operator, has asked Sweden's

regulator to postpone the 3G-rollout deadline until 2006. Tele2, a Swedish operator, is threatening to abandon its operations in Norway unless the licence terms are eased. And Spanish operators are lobbying for a refund of deposits paid for their 3G licences.

Alphabet soup

Back in the 1990s, the European Commission's decision to impose a single technology standard for second-generation (2G) phones, called GSM, on Europe's operators worked well. It allowed roaming from one country to another, and Europe's wireless firms, notably Nokia and Ericsson, rose to prominence as GSM became the dominant 2G standard worldwide.

Imposing W-CDMA as a single standard in 3G now looks like a big mistake. Far from reinforcing Europe's leadership in wireless, it has done the opposite. Morgan Stanley recently concluded that Asia now leads the world in the adoption of 3G, followed by America. Europe is last.

That is because as Europe struggles with W-CDMA, a rival 3G technology called CDMA2000 is working well elsewhere. Unlike W-CDMA, which is controlled by a huge industry consortium, CDMA2000 is controlled by a single American company, Qualcomm. Different vendors' equipment is compatible. Over 17m people in South Korea, Japan and America use a version of the standard called CDMA2000-1X (again, never mind). The industry is fiercely divided by a boring technical argument about whether CDMA2000-1X is really 3G or not. But ultimately the argument is irrelevant. CDMA2000-1X can do everything W-CDMA can; more, in fact, since it actually works. It is 3G in practice, even if not everyone agrees that it is 3G in theory.

In Japan, CDMA2000-1X and W-CDMA are competing head to head, and the results make grim reading for European operators. Japan's NTT DoCoMo launched the world's first commercial W-CDMA network in October 2001. Since then, it has signed up a mere 135,000 subscribers, far short of expectations.

Its rival KDDI, in contrast, launched a CDMA2000-1X service in April 2002, and has already signed up 2.3m customers. Half of those subscribers have camera-phones, which they use to zap pictures over the airwaves, spending an average of $11 per month more than subscribers with ordinary phones. DoCoMo's average monthly revenue from its 3G subscribers, meanwhile, is falling, the battery life of its 3G handsets is poor, and subscribers have to carry two phones if they want to stay in touch outside areas of 3G coverage.

No wonder operators everywhere that had planned to adopt W-CDMA are thinking again. The industry's consensus that W-CDMA will eventually grab 80% of the world market for 3G, and CDMA2000 just 20%, is being re-evaluated.

In South America, operators have abandoned or frozen plans to adopt W-CDMA. Telstra, in Australia, is leaning towards CDMA2000. Most important of all, in China, the world's largest mobile market, executives from China Mobile have given W-CDMA only a half-hearted endorsement. Adoption of the technology depends on it working properly, the company says, so a switch to CDMA2000 cannot be ruled out. “The question is, should you use the technology that is running today, or wait for one that may or may not run tomorrow?”, asks David Chamberlain, an analyst at Probe Research.

European operators, however, have no choice. At least one operator has established a task force to evaluate switching to CDMA2000, says Andrew Cole of Adventis, a telecoms consultancy, and others are no doubt doing the same. But as things stand, says Caroline Easter, a technology lawyer at Ashurst Morris Crisp, Europe's 3G licences are technology-specific, and any firm that adopted CDMA2000 would be in breach of the licence terms.

Even suggesting such a switch in public would have a dramatic effect on European equipment makers, which have signed lucrative contracts to supply operators with W-CDMA network equipment. Tellingly, however, a consortium of eight equipment makers—including Ericsson, Lucent, Nortel and Motorola—recently agreed to co-operate on building CDMA2000 equipment suitable for the European market.

It is not just the imposition of a single technology standard that should be reconsidered by regulators, argues Joe Nordgaard of Spectral Advantage, a consultancy. European operators are also barred from buying and selling their licences—they must simply give them back, with no refund, if they choose to abandon 3G.

Operators also have to adopt 3G in a new frequency band, rather than phase it in alongside existing 2G, as operators are doing with CDMA2000 elsewhere. But these market distortions, says Mr Nordgaard, “can be alleviated to some extent by allowing operators more freedom.”

Even if operators wanted it, however, Europe's regulators are unlikely to change the rules, even as they amend licence terms to extend 3G rollout deadlines. Defending the original policy, it seems, matters more than providing consumers and operators with a choice of technologies. Things might have been very different had Europe's operators not been trussed up in a technological straitjacket.

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Disney

Wobbly kingdom

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From The Economist print edition

Disney needs a managerial lion king

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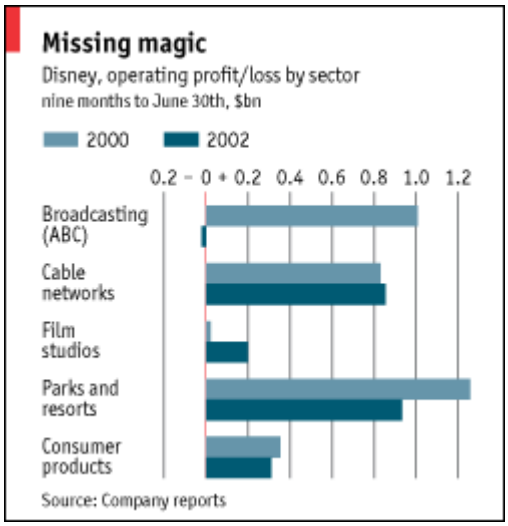
HAVING survived this week's board meeting, Michael Eisner, the head of Disney, is a rarity: the boss of a struggling media group still clinging on at the top. But the pressure on him is intense. Investors are disgruntled. Even certain members of the eccentric, usually docile Disney board—which includes a Hollywood actor, a priest and a specialist in early education—are grumbling about his failure to revive the Magic Kingdom. A list of possible successors—from Peter Chernin to Mel Karmazin, seconds-in-command at News Corporation and Viacom respectively—continues to swirl around Hollywood.

What has happened to Mr Eisner, at the helm now for nearly 18 years? Once upon a time he was lauded for the vision and iron grip with which he transformed a business that had become heavily concentrated on its theme parks, with only a small film studio, into a diversified global media conglomerate. Now he is increasingly perceived as a liability. No part of the Disney empire is insulated against trouble.

Through its theme parks, the company has been battered by the downturn in tourism. Its film studio has been boosted by last week's release on DVD and video of “Monsters Inc”, an animated film which sold 5m units in one day, a new record. But it has yet to recapture the creative touch which, in the early 1990s, delivered it animated hits such as “The Lion King”. Recently, Disney has relied for its creative energy on a partnership with Pixar, which created “Monsters Inc”. This venture only lasts for two more animated films. By contrast, Disney's own ability to devise new children's characters and turn them into classic franchises, branded on to lunch boxes, pyjamas and soft toys the world over, has faltered.

By far Disney's biggest current headache, however, is the broadcast network that Mr Eisner bought in 1996: ABC. Two years ago, when ABC topped the prime-time ratings league with “Who wants to be a millionaire?”, a quiz show, the network was throwing handsome profits into the Disney pot. In the nine months to June 2000, operating profit at ABC topped $1 billion, nearly one-third of the group's $3.2 billion total. In the nine months to June this year, however, ABC made a pro forma operating loss of $13m, dragging down the company's operating profit to $2.3 billion.

Part of ABC's problem is the advertising slump, which has especially hurt the network since it slipped from top of the prime-time ratings to third place this year, behind NBC and CBS. But ABC also faces a particular challenge. The other networks launched their new TV shows this week on the back of established hits returning for another season. ABC has none, having so over-exposed “Millionaire?” that it bores even America's couch potatoes.



Earlier this year Mr Eisner fired Stu Bloomberg and installed Susan Lyne as head of ABC Entertainment. He also recruited Steve Sohmer, a TV veteran, to overhaul ABC's marketing. Every part of Disney, from theme parks to cable channels, has been put to work promoting the new TV shows.

Early reactions to two new ABC sitcoms, “Eight simple rules for dating my teenage daughter” (see photo) and “Life with Bonnie”, are promising. Each topped the ratings in their time slots. But other new ABC series are going head-to-head with old favourites on rival networks, such as “Friends” on NBC, which this week won an Emmy award for best comedy. And even if ABC can conjure up one or two

new hits this season, that still may not be enough to reverse its fortunes. “It typically takes two to three years for a network to pull itself up,” comments Christopher Dixon, a media analyst at UBS Warburg, an investment bank.

More tricky still, Disney bears most of the risk involved in new shows, because most of those it is launching on ABC this season have been made by the Disney-owned TV production studio, Touchstone Television. By industry standards, this model is not unorthodox. Viacom's CBS and News Corp's Fox, two other networks, belong to media conglomerates, each also relying on a sister studio to feed much of its programming. This lets the network, and its giant owner, capture more of the long-term value of shows once they are hits.

The downside is that the network does not share development costs for new shows with an outside partner. And it relies on the creativity of the parent's in-house studio. Given Disney's corporate instinct to control creative ideas, an urge embodied by Mr Eisner, an English literature and theatre graduate who has never hidden his preference for the creative side, pushing the own-label model to its limits may have been counter-productive.

ABC

Michael Eisner's lucky number?

Recently, ABC and its Disney parent have begun to recognise the limits of this do-it-yourself model. Of its new shows in development, to air in a year's time, only about half are being made in-house, down from 86% of this year's debutants. “I've been aggressive in going out and telling all the studios we're open for business,” says Ms Lyne, “No one studio can deliver all the programming a network needs.”

ABC is exploring other changes. Last month it signed a programming deal with HBO, a premium cable channel behind the hit comedy “Sex and the City” and such classy dramas as “Six Feet Under” and “The Sopranos”. HBO is owned by AOL Time Warner—and Disney is also talking to that rival media giant about a cost-cutting joint venture to merge CNN, a cable news channel, with ABC's broadcast news.

Plainly, Mr Eisner would not have hired Ms Lyne had he not approved of the idea of fishing in a wider Hollywood creative pool. To that extent, he is prepared to let go, at least a little. “It's ridiculous to think that Michael would be reading scripts and watching rough-cuts,” insists Ms Lyne. Maybe so. Yet a tension remains. Mr Eisner could not resist sitting in on discussions about scheduling for this season, and which shows the network should broadcast. If ABC fails to pull off a revival, he will have nobody to blame but himself.

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Vivendi Universal

Plus ça change

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Whither France's global media dream?

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THERE was one irony, and few surprises, in the strategy for Vivendi Universal announced on September 25th by Jean-René Fourtou, its boss since July. Mr Fourtou was drafted in to rescue Vivendi from bankruptcy after Jean-Marie Messier left in disgrace, having chased a financially reckless dream of turning a dull French utility into a global multi-media giant. So would Mr Fourtou return the company to its French roots based in utilities? Not a bit of it. “Vivendi Universal is basically an entertainment company,” he declared. It will keep its American film studios, music and television assets, run by Barry Diller, after all.

This irony might make strategic sense were Mr Fourtou clear about his plans for the non-media assets. Yet he insisted he had no wish either to raise or reduce Vivendi's 41% stake in Vivendi Environnement, a utilities firm. He would not make clear any plans for Vivendi's minority stake in Cegetel, the majority owner of SFR, a cash-generating mobile operator. Without control of Cegetel, Vivendi cannot get its hands on that cash. A fight to boost its stake would pit Vivendi against mighty Vodafone, a telecoms firm and Cegetel shareholder.

That left a less glittering list of assets to be shed to pay down Vivendi's *euro*19 billion ($18.6 billion) net debt. Mr Fourtou promised to raise *euro*12 billion from asset sales by December 2003; *euro*5 billion of them by next March. The big prize is Vivendi's publishing unit. Some bids are already in, and the sale might bring in around *euro*3.5 billion. Mr Fourtou also announced the sale of Telepiu, a cash-draining Italian pay-TV operator, to Rupert Murdoch's News Corporation for *euro*1 billion, two-thirds of the price discussed a year ago. A minority stake in Vivendi's games unit will be “monetised”, possibly via a separate listing.

The rest must come from smaller assets, such as Canal Plus's foreign units and Messier-era extravagances such as corporate jets and flashy property. Last month, Vivendi sold Vizzavi, an Internet portal, to Vodafone for *euro*143m. This week it sold Canal Plus Technologies to Thomson Multimedia for *euro*190m.

Mr Fourtou is treading a perilous line between his creditors' need for cash and his investors' hunger for strategic clarity. He does not want to make any fire-sales. Yet, as he admitted, even with the *euro*3 billion medium-term credit line he secured last week, replacing an earlier *euro*1 billion loan, the liquidity crisis “is not perhaps behind us, but is being resolved”.

Mr Fourtou's plans underline the collapse of the idea of “convergence” in the media industry. Telecoms, regarded by Mr Messier as the centrepiece of his vision of marrying old and new media, is now just a cash cow; Vivendi's Internet units a cash drain. Mr Fourtou may still have to prove what his strategic vision is; but it is quite plain what it is not.

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Drug side-effects

Pain killer

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Its maker may finally have to admit that Tylenol can be a dangerous drug

AFTER 25 years of study, a Food and Drug Administration (FDA) advisory panel decided last week to recommend that acetaminophen, the active ingredient in Tylenol, America's most popular non-prescription drug, should carry an explicit warning about potential liver damage. “You cannot allow more innocent men, women and children to suffer,” said Kate Trunk at the FDA hearing before the advisory panel's vote. Her son recently died from liver disease after taking an acetaminophen drug after injuring his wrist.

Even the possibility that a problem exists in acetaminophen came as a shock to many Americans, 55m of whom use Tylenol each year. Johnson & Johnson (J&J), a big drugs company, made Tylenol into a huge success with an advertising campaign boasting, “nothing's safer”. The reputation of product and firm were intertwined in 1982 when J&J immediately responded to a tampering incident that cost seven lives, recalling every package. The incident became the most famous case study in corporate social responsibility.

But while J&J was quick to address external threats to Tylenol, it only grudgingly faced up to problems with acetaminophen itself. The distinction between a safe and a harmful dosage is particularly narrow and it can be toxic in relatively small quantities. According to documents that emerged in lawsuits, J&J was aware that explicit health warnings would damage Tylenol sales. Perhaps not coincidentally, its labels in most cases bear no reference to the potential harm in taking acetaminophen.

Each year there are 56,000 emergency-room visits because of acetaminophen overdoses, and 100 fatalities, says the FDA. According to William Lee of the University of Texas Southwestern Medical Centre, acetaminophen is the leading cause of acute liver failure. In a recent FDA study of patients with liver damage linked to acetaminophen, 20% had used less than the recommended daily dosage.

Yet Tylenol-related lawsuits have rarely succeeded. It is difficult to link cause and effect definitively in a medical case. Many people use the drug without problems. Often, J&J has in effect argued that the victim could not prove that the recommended dose had been precisely followed. Even so, in 1994, it lost a $9m verdict to Antonio Benedi, whose liver was destroyed by Tylenol. Mr Benedi had taken it as directed, along with a little wine.

Soon after, J&J started to include a vague warning with each adult Tylenol package, noting that liver damage could result when the drug was mixed with alcohol. It did not explicitly warn consumers that liver damage was possible from taking Tylenol even without alcohol.

An FDA panel first proposed requiring a warning linking acetaminophen to liver damage in 1977. It did so again in 1988 and 1993. Most of the data used by the FDA in making its recommendation, it concedes, has long been known. For the warnings to become mandatory, the FDA must formally adopt the recommendation, and it may face lobbying like that which stymied past attempts. This week a new boss was nominated for the FDA, Mark McClellan, an economist on the Council of Economic Advisers. For insight into the opportunity costs of bureaucratic delay, Ms Trunk would be a good person for Mr McClellan to consult. Sadly, she is not alone.

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Doing business in Zimbabwe

Aasvoels circling

Sep 26th 2002 | HARARE AND JOHANNESBURG
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Vultures are eyeing Zimbabwe's firms

IF THE best time to invest is when blood is in the streets, Zimbabwe offers a promising opportunity. The country is in the throes of political upheaval, with 6m hungry people, an inflation rate of 135% and a shrinking economy. The rule of law is collapsing. Judges are routinely intimidated. The government sends thugs to grab commercial farms. And fears are growing of much worse civil strife to come.

Enter the bargain hunters—call them *aasvoels*, Afrikaans for vultures. Zimbabwe boasts vast quantities of valuable minerals, including one of the world's largest deposits of platinum. South Africa's Impala Platinum recently upped its shareholding to take effective control of Zimbabwe Platinum Mines. It has also increased its stake in a smaller platinum company, Mimosa. Platinum sells for $574 an ounce, and the low costs of mining it in Zimbabwe mean that both ventures are too tempting to pass up, despite the political risk, says Keith Rumble, Impala's boss.

Zimbabwe's fuel and energy shortages are also tempting outsiders. President Robert Mugabe's Libyan allies have just renewed an annual $360m deal to cover most of the costs of importing oil. The Libyan government will get assets once owned by the Zimbabwean state, including 14% of Jewel Bank and 14% in Rainbow, a tourism group, and maybe some land. Talks are said to be under way to give Libya control of fuel tanks in Harare and a strategically vital oil pipeline linking Zimbabwe to a port in Mozambique.

Eskom, South Africa's energy utility, the world's fifth biggest, is eyeing Zimbabwe's energy giant, Zesa, which is slated to be privatised. Zesa is far short of the $200m or so in hard currency it needs each year to pay for equipment and to service debts accrued to Eskom, which supplies electricity to Zimbabwe's grid. The South African supplier may hope eventually to swap debts for a share in the Zimbabwean company, and is building a close partnership. Zesa is increasingly reliant on the support of its South African big brother.

Most South African companies are understandably wary of doing business in Zimbabwe—until recently South Africa's biggest African trading partner but now down to third place. Anglo American is reducing its investment in its citrus and timber estates there, though it plans to retain its much more lucrative mining interests.

Other large trading firms still see opportunities. Last year Barloworld bought a Zimbabwean cement and lime producer. South African Breweries is keeping its 25% stake in Delta, a beverage company. “There is huge consumer spending power in this market for trading companies. Often people here have money for goods, but nothing to buy,” says John Robertson, an independent economist in Harare.

The World Food Programme expects to spend one-fifth of its $500m food budget on transporting grain within the region, about half of it in Zimbabwe. Private-sector haulage firms, many of them South African, charge up to $90 for every tonne shifted. Other private traders are finding original ways to get goods to Zimbabwean consumers. Two online firms, Sadza.com and Emoneytransport.com, let well-wishers overseas send money and food to relatives in Zimbabwe via local supermarkets. The situation is desperate for most, but a few firms may have reason to smile.

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Accounting scandals

Worthless promises?

Sep 26th 2002 | NEW YORK
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Was American bosses' first certification of accounts a non-event?

REMEMBER the fuss around August 14th, the date by which America's corporate chieftains had to swear personally to the accuracy of their companies' accounts, under orders from the Securities and Exchange Commission (SEC)? This was supposed to restore the confidence of investors, savaged by accounting scandals from Enron to WorldCom. Certification, carrying with it the prospect of criminal prosecution for the signatories if the accounts later proved to be fraudulent, would presumably not be done lightly. Bosses hated the idea, and spent small fortunes on legal advice.

It was widely believed that certification would boost the share price of those firms whose bosses signed, while hurting those whose bosses declined to do so. What actually happened is the subject of a new study by Utpal Bhattacharya, Peter Groznik and Bruce Haslem of the Kelley School of Business at Indiana University. They examined the share prices of 762 firms, 688 of which had to certify by August 14th and 74 that certified voluntarily, seeking out any impact of certification or non-certification.

They found crucial differences between the 738 firms that provided a pro-forma certification, the 15 that certified using their own words and caveats, and the nine that failed to certify at all. The nine tended to be firms that had restated their accounts in the previous year, were financially distressed, had a relatively low proportion of institutional shareholders and were audited by, you guessed it, Andersen.

But on the crucial question of its impact on the stockmarket, they found that, on average, announcing that a firm had or, more strikingly, had not certified made no significant difference to its share price. The likeliest explanation for this, say the three economists, is that the market was not in the least bit surprised by those firms that stood by their accounts and those that did not. Indeed, the study suggests, share-price movements indicate that the market had sorted out the corporate sheep from the goats by April 2002, well before the SEC made its certification order in June.

Or perhaps investors had so lost faith in CEOs that they dismissed their signatures as empty pledges not worth the paper they were written on. Whatever, says Mr Bhattacharya, certification seems to have been “a non-event”.

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An innovative Japanese restaurant chain

Food for thought

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Global Dining is revolutionising Japanese work practices

TRADITIONAL *ryotei*, where elegant kimono-clad women serve dainty dishes and fragrant sake, are usually the dining spots of choice for foreign heads of state visiting Tokyo. But when George Bush arrived earlier this year, Junichiro Koizumi, the prime minister, took the American president to Gonpachi, a huge, trendy tavern in Tokyo's hottest night spot. In contrast to the discreet formality of *ryotei*, the bustling, occasionally raucous Gonpachi, decorated with fat sake kegs and strings of paper lanterns, suited Mr Koizumi's populist image and helped to show off an easy bond with his buddy, Mr Bush.

The visit was a huge feather in the cap of Kozo Hasegawa, the maverick founder of Global Dining, which owns Gonpachi and a string of other popular restaurants, including a couple in California opened as a pilot for a possible global expansion.

Global Dining restaurants offer decent food at a reasonable price and stay open late. The restaurants have funky themes, ranging from the Gothic splendour of Tableaux, which offers Californian cuisine, to its latest venture, the disco-style Dancing Monkey, complete with glittering mirrored balls and zebra-patterned floors.

But Global Dining's greatest strength is its efficient and attentive service, fostered by vigorously defying traditional Japanese business practices. A decade after Global Dining started life as a coffee shop in 1973, Mr Hasegawa concluded that its conventional Japanese seniority system bred complacency, causing his restaurants to lose customers and money. Now the firm, which has annual sales of ¥11.7 billion ($98m), boasts a competitive system of carrots and sticks for workers that might shock even ruthless American employers.

Most of the 1,400 staff are hired first as part-timers, mostly in their 20s and on minimum pay. To get a raise, they must win the backing of a majority of their co-workers at one of the regular staff meetings. A thick skin is essential, as colleagues tend to be blunt in their discussion of strengths and weaknesses. Applicants take criticism—which has been known to address subjects such as overly-strong body odour—in their stride. So much for the traditional Japanese workplace, full of passive workers strenuously avoiding confrontation and personal accountability.

Life gets no easier higher up the ladder. Increasing sales, a restaurant manager's top priority, is tough given the sagging economy. Poor performance leads to demotion, while the successful are rewarded just as swiftly. Naonobu Takashima, the 25-year-old manager of La Boheme—themed as a medieval European castle—was hired as a part-time waiter in March 2001 on ¥850 ($7) an hour. Six months later, he was put in charge of one of Global Dining's leading outlets. He now earns around ¥15m a year, a rapid seven-fold increase perhaps unprecedented in Japan.

Global Dining's culture is winning influential admirers. Some senior executives at blue-chip firms are so impressed that they are sending their offspring to be trained at the restaurant chain.

After a TV programme on Mr Takashima's meteoric rise, busloads of restaurateurs from across Japan started visiting La Boheme to watch the young star in action. There have been some typically Japanese side-effects. Some traditional businessmen, who spent decades climbing the corporate ladder, found his rapid success hard to accept and abused him on the firm's website. He was even heckled at work.

Global Dining's meritocracy has forged an army of highly professional workers, trained to make wide-ranging decisions on how a restaurant should be run. They are tempting recruits for rivals. Even Global Dining's drop-outs are mostly considered better than average industry workers and are soon hired

elsewhere.

There was a huge exodus after Global Dining went public in 1999. A quarter of its managers cashed in share options and left to start their own restaurants. Not only did it lose some of its stars—some of them also became its fiercest competitors. Global Dining's share price has plunged by 90% since listing its shares. Analysts say the main problem, apart from a market-wide collapse in share prices, is its failure so far to nurture a big batch of new talent.

Mr Hasegawa agrees and is searching for ways to keep the best of the current workforce. One idea is to let them come up with—and execute—concepts for new restaurants. That way, he says, they can enjoy much of the freedom and excitement of starting a business themselves, but with a financial safety net and a ready-made pool of good staff. Perhaps quite soon, an even bigger prize will be on offer. Unusually in a country that prefers to keep businesses in the family, the 52-year-old Mr Hasegawa says his own job will be up for grabs in an open competition when he retires.

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Face value

Ex-friends of Frank

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If being a friend of Frank Quattrone was wrong, how should company bosses relate to their bankers?

AMERICA today is not short of corporate scallywags. But historians may reserve a special place in the crowded gallery of rogues for Frank Quattrone. Mr Quattrone was an investment banker who wheeled and dealed his way through the 1990s and a string of ever-more-generous employers to fame and fortune. But what really marked him out were his social talents. Mr Quattrone was a very friendly man.

He had an apparently straightforward approach to making friends. His job was to find technology firms for his employers to sell via initial public offerings (IPOs) of shares. At 7% of the money raised, IPO fees are famously good business. Most of the newly issued shares, which typically soared in value on their first day of trading, went to the big investing institutions. But at Credit Suisse First Boston (CSFB), Mr Quattrone's employer since 1998, a few IPO crumbs fell into the laps of the brokers who worked alongside him. These brokers reportedly ran what were dubbed “Friends of Frank” accounts, opened on behalf of executives of valued tech-company and venture-capital clients that Mr Quattrone hoped to befriend. Into these accounts went the fresh IPO shares. Then, once they had risen nicely, CSFB's brokers would “flip” or “spin” them to less fortunate buyers, booking the profits for Frank's friends—a business gift, as they say in Saudi Arabia.

Like much of what passed as industry practice during the late 1990s, spinning is now under investigation by everyone from securities regulators to Congress. Already, besides CSFB, these investigations embrace Citigroup (owner of Salomon Smith Barney), Goldman Sachs and others. The wickedness of Wall Street's bankers no longer surprises.

More intriguing is the behaviour of those chief executives, chief financial officers and others who took these gifts from Mr Quattrone and his ilk. It was their clear duty to get the best possible deal for their shareholders. Yet new issues were routinely priced far below the market-clearing price. It now seems not unreasonable to think that many managers may have tolerated these practices for personal gain.

Time was, seasoned investment bankers will tell you, that this sort of relationship between a company and its banking advisers could not have existed. No-one can exactly date this golden age of banking, though some wistfully recall the era of John Whitehead and John Weinberg at Goldman Sachs, especially in the 1970s when that firm was in its prime. In this age, before the fall, strode men of professional integrity and moral clarity, dispensing, if need be, the icy blast of truth to their clients. Well, that's the story.

Sin comes to Wall Street

Then came the fall. In 1975, fixed trading commissions ended, and competition and deregulation were let loose. Financial innovation thrived, creating huge opportunities for making money. New markets arose in mortgage-backed securities, junk bonds and leveraged buy-outs. Providing professional, independent advice suddenly looked like a poor man's game.

The monthly retainer withered away and banks began demanding a percentage of the deal. At a stroke, they lost their ability to provide impartial advice: the overwhelming incentive was to close the deal almost regardless. But as the markets in mergers and IPOs boomed, the rewards looked worth it.

Some captains of industry were terrified by this new, barbarian-filled world of finance. Others quickly came to understand its logic. Bankers could never be trusted to give impartial advice. But when opportunity for mutual benefit arose, they could become your partners.

As the great bull market of the 1990s rumbled on, the partnerships deepened. When corporate bosses berated their bankers for unenthusiastic research reports by their analysts, those analysts jumped. Eager to close the latest deal, bankers massaged egos, playing to the strong sense of hubris in America's boardrooms. Jack Grubman, a Salomon Smith Barney star analyst, even sat in on board meetings at WorldCom, a deeply corrupt telecoms firm, offering advice. Looking after the boss with hot IPO stocks, as Mr Quattrone and others did, symbolised and sealed the partnership between bank and company.

The problem, of course, is that independent advice can sometimes prove priceless. Who was there to caution against the mad stampede of telecoms firms into fibre-optic cable? Or that miserable marriage of old and new media in the merger of AOL and Time Warner? “Hardly anyone was fairly compensated to work on the other side of the market,” says Charles Ellis, the founder of Greenwich Associates, a research firm. “Everyone's interests were the same.”

The market's collapse has brought this game to a jarring halt. From 2000 to 2001, merger volumes halved. This year, they will fall again. There are good deals to be done—in the telecoms industry, for instance, which needs consolidating. But any banker proposing one is likely to get short shrift from today's bosses, ever mindful of their suddenly suspicious board members. Today, no investment banker can be trusted. Where are Frank's erstwhile friends now?

So, have bosses regained their appetite for independent counsel? And if so, who will provide it? Investment banks must wrestle with the huge cyclicality, conflicts of interest and brand damage that their past choices have bequeathed them. Perhaps new leaders will make better choices. But the risk is that the banks will fall apart under their conflicts of interest, replaced by advisory banking boutiques or management consultants. While the rewards for advising on deals remain large, however, genuine independence may prove elusive. Bosses should remember Mr Quattrone next time some hired hand urges them to issue securities or merge. Beware advisers bearing gifts.

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The IMF

Doubts inside the barricades

Sep 26th 2002 | WASHINGTON, DC
From The Economist print edition

It is not just anti-globalisation protesters who are wondering whether the IMF knows what it is doing

Get article background

THE International Monetary Fund (IMF) and the World Bank will again be under siege this weekend. Thousands of anti-globalisation protesters intend to encircle the organisations' Washington headquarters—where finance ministers and central bankers from 184 countries hold their annual meetings on September 28th and 29th—in order to save the world from the “economic smallpox” inside. After a brief lull in the wake of last year's terrorist attacks, the travelling circus of anarchists, students and activists, who try to wreck international economic meetings with what they call “creative confrontational opposition to capitalism”, is back.

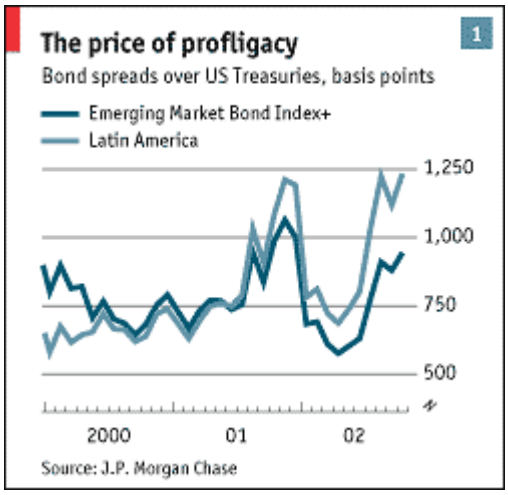
Though these banner-wavers hog the headlines and disrupt the streets, they pose no serious threat to the two Bretton Woods institutions. Their goals (such as “end capitalism”) are too absurd; their arguments too incoherent. But this year, more than most, the IMF faces criticism from a more serious source—those inside rather than outside the barricades. A growing chorus of insiders, from staff members (*sotto voce*) to Wall Street bankers (more loudly), is asking whether the Fund and the rich countries that largely determine its policies know what they are doing.

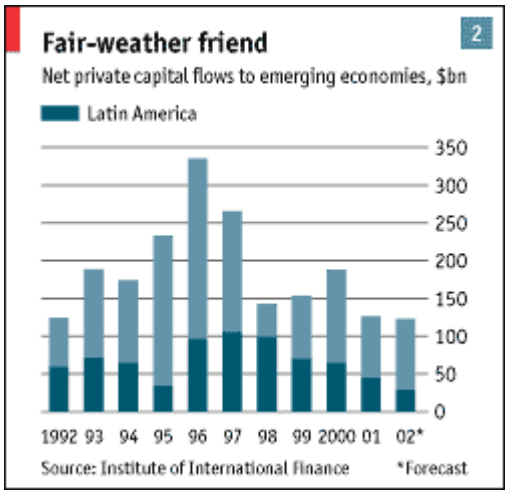
The reason for the current disquiet is Latin America. A region that was only recently the darling among emerging markets now includes several countries that sit on the edge of financial disaster. Argentina has already fallen into the abyss. Its default on its external debt triggered an economic depression without parallel there since the 1930s. Its economy could shrink by more than 15% this year.

The collapse has dragged down Uruguay, Argentina's next-door neighbour, a country whose debt long held a prestigious investment-grade rating. An American bridging loan and an IMF bail-out averted a banking crisis there in August, but most observers—and, privately, even economists at the IMF—say it is a matter of when, not if, Uruguay defaults.

Now uncertainty about the outcome of its presidential election in October has pushed even Brazil, the region's giant, to the wall (see article). A pre-election financial catastrophe was staved off only by a $30 billion IMF loan in August, the organisation's biggest ever. Elsewhere, Paraguay has turned to the Fund for the first time since the 1960s, and Ecuador and Colombia are both in trouble. Chile and Mexico are the sole bright spots in a region whose GDP, according to some forecasters, will shrink by around 1% this year.

Most countries in the region have been squeezed out of the international capital markets. The interest-rate spread between US treasury bonds and the average Latin American bond is over 1,200 basis points, or 12 percentage points, almost double the spread earlier this year (see chart 1). According to the Institute of International Finance, Latin America will see only $29 billion of net private capital inflows this year, compared with $45 billion last year and $106 billion five years ago (see chart 2).





For the IMF, Latin America's current plight is the latest disaster in a litany of emerging-market crises over the past decade—from Mexico's currency crisis in 1994-95 to the Asian financial crises of 1997-98 and Russia's default in 1998. Cumulatively these have already deeply dented the organisation's credibility as a font of good economic advice. The Fund's main explanation for previous mistakes—that it was practising “battlefield medicine”—is less credible this time round. In Asia, it had to decide quickly how to cope with sudden exchange-rate crises in countries with which it had not been closely involved for years. In Russia, it was assisting in an unprecedented switch from communism to capitalism. In both cases, mistakes were to be expected. Latin America, in contrast, is a region in which the IMF has been immersed for decades.

In the 1990s, in particular, it was midwife to the region's embrace of economic reform—of the deregulation, liberalisation and privatisation that make up the so-called “Washington Consensus” of policies for emerging-market prosperity. Latin American countries slashed trade barriers, sold off state assets, and opened their financial systems to foreign capital. Given the Fund's close involvement, even Horst Köhler, the IMF's boss, recently admitted that the failure to avoid the current turmoil “suggests that we still have a lot to learn”.

Consensus objectors

What should these lessons be? The criticisms of the IMF are numerous and not always consistent, but three big themes stand out. One line of argument blames the current turmoil on Latin America's failure to adopt the Washington Consensus with sufficient rigour. Ernesto Zedillo, Mexico's former president, for instance, wrote recently in *Forbes* magazine that the region suffered from too little reform rather than too much.

It has become conventional wisdom in recent years that sustainable growth in Latin America demands more than liberalisation and privatisation. Deeper structural change—from improving education to overhauling judicial systems—is necessary. But, this analysis suggests, disciplined policies are a prerequisite. The lesson is that the Fund must become tougher.

A second line of argument suggests that parts of the Washington Consensus itself are to blame: that the Fund pushed countries into opening up their economies to foreign capital prematurely, and that this openness lies at the heart of the current turmoil. In its extreme form, this critique is often associated with Joseph Stiglitz, a former chief economist at the World Bank and author of a recent book which denounces the IMF as the ideological handmaiden of Wall Street. While few insiders agree with Mr Stiglitz's analysis, there is a growing disquiet even among the IMF's own economists about the risks involved in foreign capital flows, particularly the debt finance that many Latin American countries have binged on recently.

The third set of criticisms, offered mainly by Wall Street financiers and others who have lent to emerging markets, blames the IMF and its political masters, especially America, for inconsistency. During the

Clinton years, countries that faced financial crises were given large IMF loans in exchange for tough policy reforms. But the Bush administration was determined to change this, worried that a culture of bail-outs led investors to reckless lending. Thus Argentina was eventually left to default in December 2001.

Since then, however, the IMF has actually given huge financial packages to Brazil and Turkey even as Paul O'Neill, America's treasury secretary, has decried bail-outs. According to many in the private sector, this inconsistency, coupled with the absence of any real American engagement in Latin America, lies behind much of the recent trouble.

Silence and the damned

There is some truth in all of these criticisms. Despite the hype of Latin America as a model pupil, a lot of important reforms did not get done during the boom years of the early 1990s. In particular, governments continued to spend too much. Though budget deficits seemed under control, the reality was invariably less rosy. Too often, the cash that came from large-scale privatisation was used to avoid tough budget choices.

In a recent book, Michael Mussa, the head of the IMF's research department until summer 2001, analyses this process in Argentina's case. (“Argentina and the Fund: From Triumph to Tragedy”, published by the Institute for International Economics.) Mr Mussa points out that for all Argentina's spectacular successes (such as its quashing of hyperinflation), the country never got its fiscal accounts in order. Between 1993 and 1998, when the Argentine economy was growing at an average of 4.4% a year, the ratio of public debt to GDP rose sharply from 29% to 41%.

Government profligacy, particularly in the mid-1990s, spawned the debt problem that sank the Argentine economy last year—and the IMF failed to stop it. Although the Fund's economists would complain about the budgets privately to the Argentines, the Fund never publicly made a fuss or halted a loan programme. One reason for this spinelessness, Mr Mussa argues, is that the Fund's economists got too close to their clients.

Mr Mussa's critique has clearly resonated inside the IMF. Claudio Loser, an Argentine economist and long-time boss of the Latin America department, has been booted out, along with a number of his key staff. He has been replaced by Anoop Singh, an Indian who speaks little Spanish and no Portuguese, and whose most recent big assignment was in dealing with Indonesia's problems. Mr Singh's instructions from the top are clear: find a new way of dealing with Latin America.

Shuffling the staff may help the Fund become, or at least appear, tougher. But the truth is that when financial markets are pouring money into a country, it is hard for the IMF to have much clout. In the good times, it is often sidelined: Brazil, for instance, had no loan programme with the Fund as its debt burden began to soar in the mid-1990s. And even when the Fund is around, it is easier to ignore. In 1997 and 1998, exactly when Mr Mussa argues that the IMF should have been tougher, Argentina was a darling of emerging-market bond investors. Even if the IMF had blown a whistle loudly, it is hard to believe that it would have made much difference.

The volatility of portfolio finance—its tendency to pour in when investors are confident, and flee just as suddenly—is the main reason for growing scepticism about the whole process of foreign borrowing by emerging-market economies. Each of the debt crises of the past decade has taught lessons; in particular, the danger of a pegged exchange rate. But Brazil's current turmoil shows that even countries that appear to do everything right, can suddenly get into trouble.

Brazil has a big debt burden, the relic of inadequate fiscal discipline in the mid-1990s and failed efforts to defend an exchange-rate peg in 1999. But it is a burden that few bondholders worried about until early this year. Moreover, since 1999 Brazil has had exemplary economic management. Its exchange rate floats; its banking system is strong; and it has run a budget surplus (excluding interest payments) of over 3% of GDP. Yet, earlier this summer, concerns about the outcome of October's presidential election, and sudden jitters about the country's ability to sustain its level of debt, sent real interest rates into double digits and raised the risk of default.

For some critics, Brazil's predicament is a sign that the system is broken. Dani Rodrik, a professor at Harvard University, says it shows that the Washington Consensus model “has run out of excuses”. He argues that anyone “who still thinks this is an efficient system for resource transfer is mad.” Few others go that far, but the cumulative impact of the emerging-market financial crises of the past decade

suggests that foreign-currency denominated debt, borrowed in any quantity, whether by the private sector or the government, is dangerous. While many academics, including Ken Rogoff, who replaced Mr Mussa as the IMF's head of research, were warning of the dangers of debt finance in the 1980s, the IMF did little publicly to discourage it during the 1990s.

In Latin America, the failure to sound warnings more loudly is particularly blameworthy. After all, this is a region whose history is littered with surfeits of foreign borrowing. Although the region's debt burden, measured as a share of GDP, is not particularly high (far lower, for instance, than that of countries in emerging Asia), it is extremely high compared with its exports. Latin America's trade integration with the rest of the world is far less advanced than its financial-market integration, partly thanks to rich-country protectionism. And, as a study in the latest IMF *World Economic Outlook* makes clear, countries with deep financial integration but low trade integration are particularly prone to debt crises and currency crashes.

So debt is dangerous, especially in Latin America. But given that many countries have already borrowed up to the hilt, what is to be done? Mr Rodrik argues that the answer is to roll back the clock, give up on the Washington Consensus and reinstate capital controls. Only then, he argues, will Latin America's economies have the breathing space that they need to get any economic growth.

That view is not widely shared. It is becoming conventional wisdom (and indeed IMF policy) that countries which have not opened their financial systems to portfolio capital, such as China and India, should do so slowly and cautiously. But few suggest putting the genie back in the bottle in Latin America, at least not for ever. The region has a long history of capital controls that fostered corruption and were widely evaded. The wealthy simply smuggled their assets abroad, resulting in less investment and growth at home.

A new chapter on bankruptcy?

If debt finance and capital controls are both a bad idea, what is to be done? For now, both the IMF and its political masters are focusing on finding better ways to deal with financial crises. If defaults can be made less destructive, the argument goes, debt is less dangerous.

In November 2001, Anne Krueger, the IMF's number two, floated an idea whose outlines had long been peddled by academics, but never publicly embraced by any international economic officials: that the world needed the equivalent of a bankruptcy system for countries. The proposal was greeted with scepticism from many governments, and with outrage by investment banks and bondholders, who reckoned it would spell the end of emerging-market debt finance. Few expected the idea to go anywhere at all.

In April this year, Ms Krueger offered a less dramatic version. The Fund's laws should be changed, she argued, to allow a super-majority of creditors to restructure a country's debt. Once such a majority agreed to the terms of a workout, any dissatisfied bondholders would be prevented from challenging it. This arrangement would not legally extend the Fund's power, but it would override current American law, which allows any bondholder to sue for full payment in the event of a default.

In recent weeks, Ms Krueger's plan—called the SDRM (Sovereign Debt Restructuring Mechanism)—has suddenly gained momentum. At their meeting this weekend, the IMF's political masters are likely to ask the Fund to draw up a detailed proposal over the next six months for how to put it into practice.

Does this mean that bankruptcy rather than bail-outs will be the way to deal with all crises? That would be a huge change in the IMF's role. Ms Krueger is less ambitious. She sees the SDRM as a useful tool, one that would help countries whose debt burden was clearly unsustainable (such as Argentina). She imagines the procedure being used perhaps once every three to four years. But in cases where a country faced a liquidity crunch, such as Brazil, the IMF would still need to lend, big time. To drive that point home, Mr Köhler last week suggested that the Fund could need more money in order to be able to deal with capital-account crises.

The Fund's largest shareholder, however, appears to have a different view. The Bush team's goal is to reduce the need for bail-outs. Mr O'Neill lamented recently that the world faces two uninviting options when a country hits trouble today: “unwarranted lending or sending the troubled nation off a cliff and into a catastrophic default.” Privately, the Bush team are quite clear that they want to build a system where emerging markets restructure their debt smoothly and more frequently. Bail-outs are to be

minimised.

But to make matters even more complicated, America's actions belie this position. It pushed for the huge bail-out of Turkey, presumably to support a key ally in the war against terrorism. And in Uruguay and Brazil it was keen for the IMF to dole out cash quickly. The generous interpretation of this inconsistency is that the mechanisms for debt restructuring do not yet exist, so bail-outs are an unfortunate, temporary reality. But the truth is that America is hardly rushing to create a better system. Of all the big shareholders of the IMF, America was for long the most hostile to pushing ahead with the SDRM. And America is still loth to develop explicit rules that set limits on how much a country can borrow from the IMF.

Some uncertainty about whether the Fund should push bankruptcy or offer bail-outs is inevitable. Unlike a firm, it is hard to decide whether a country is insolvent or suffering from a market panic. Brazil, for instance, does have a big debt burden. But it is also following tough policies. Nonetheless, the current incoherence over policy is extreme and comes at a particularly dangerous time. The world economy is weak as the excesses of the equity bubble are being unwound. Latin America faces years of hangover from its debt binge of the 1990s. For it to recover without undoing all the other positive aspects of a decade of economic reform will be hard. That the IMF's political masters are adding extra confusion is unforgivable.

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Europe's tumbling stockmarkets

Feeling for the floor

Sep 26th 2002 | FRANKFURT
From The Economist print edition

Europe's stockmarkets are suffering even more than America's

AT LAST, on September 25th, some cheer. Despite another wretched economic report—this time, the fourth straight monthly fall in Germany's main index of business confidence—Europe's stockmarkets managed a little rally. Even so, scarcely a dent was made in the balance of the past few weeks, which has been shocking even compared with the feeble performance of American shares.

Until mid-July, give or take, Europe's bourses had plotted much the same poor course as America's since the start of 2002, losing one-fifth or so. Since then, American and British share prices have slid, but continental European shares have tumbled. By September 25th, America's S&P 500 had lost 27% this year, much the same as Britain's FTSE 100. France's CAC 40, however, was 40% lower. Germany's Xetra Dax, which this week hit its lowest point since January 1997, was down by 43%.

To be sure, America continues to dominate European markets. Time and again, falls in Europe are reversed if New York traders wake up feeling sprightly. A chirpy mood in the European morning is often spoiled after lunch by bad news from America. In the past few years, the correlation between American and European markets has increased. In the mid-1990s it was perhaps 0.4—with 0.0 meaning no correlation and 1.0 representing total correlation. Lately it has been 0.8-0.9, close to lock-step.

Closer economic ties, driven by huge investments by European companies in North America, may explain much of this change: one-fifth of corporate Europe's revenues come from North America, says Richard Davidson of Morgan Stanley. On top of this, it seems that correlations among national markets rise during periods of stockmarket boom and bust. When markets were roaring, up to the spring of 2000, investors piled into equities, regardless of nationality. Now they have turned against equities with a similar lack of discrimination.

Still, the latest trouble in European stockmarkets is more than a mere echo—or amplification—of an American tune. For a start, European economic growth has disappointed this year, with no sign that the continent is about to take over from America as the world economy's main motor. Economists have been slashing their forecasts accordingly. Europe's less flexible product and labour markets are less well

equipped than America's to adjust nimbly in difficult times. Meanwhile, America's Federal Reserve, although it left interest rates alone on September 24th, looks more ready to ward off deflation, if necessary, than does the European Central Bank, which frets still about inflation.

As a proportion of stockmarket capitalisation, the share of telecoms companies—a particularly troubled sector—is twice as big in Europe as it is in America. In Europe, banks and insurers—other sectors under stress—also account for a slightly bigger share of the total market than in the United States. Yet European firms have performed worse than their American counterparts almost across the board. In the past month, the Dow Jones Euro Stoxx indexes have underperformed their American equivalents in 16 out of 18 sectors.

The plight of Europe's insurers adds a special, nasty twist. Typically, 60-70% of British life insurers' assets are in equities, compared with perhaps 20-30% for continentals and almost nil for Americans. Regulations oblige European insurers constantly to mark their portfolios to market—and to offload shares if their value falls too much. Although British regulators have eased these requirements somewhat for the insurers that they oversee, companies have nonetheless been forced to sell shares into a falling market. That has pushed prices down further. The insurers' own share prices have also been dropping dramatically.

Worse still for Europe, says Avinash Persaud of State Street, an American bank, Europe lacks America's “built-in stabilisers”. Through mutual funds, for example, America has a certain amount of near-automatic retail demand for shares. It also has a better developed market for corporate bonds, offering institutional investors an alternative to equities. Then there are value investors hunting for bargains. Europe, he reckons, also has contrarians who think that the market is oversold. The regulation of insurers, however, overrides this variety of opinion. “Regulators have yet to learn,” he says, “that trying to limit the losses of all the people all the time means there is no one left to buy when markets are going down.”

How far are they going? Some strategists believe that after their latest plunge, European markets are at last looking fairly valued, or even cheap. Still, says Nigel Richardson of Axa, a big French insurer, “no one wants to catch a falling knife.”

“No one wants to catch a falling knife”

In one respect, though, the dive in share prices has hurt Europeans less than it has hurt Americans. By and large, Europeans have a much lower share of their wealth—especially their pension funds—in the stockmarket. So the knock-on effects of the market crash on consumer spending, and hence on the economy, should be less in Europe than in America.

Less, but perhaps still significant. Meanwhile, there may be longer-term damage, too. Not long ago Europeans, and above all Germans, seemed at last to have been converted to a love of equity, both as an investment and as a way of raising capital. In the past couple of years, falling share prices and rising frauds have taught them the hard way that equity does not mean easy money. A good lesson. Yet it would be a shame if Europe's young equity culture was buried by the market avalanche.

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The Bank of Japan

A great risk, for what reward?

Sep 26th 2002 | TOKYO
From The Economist print edition

The Bank of Japan's bid to explain itself takes it further out on a limb

AP

Hayami's catalytic conversion

Get article background

WHEN central bankers gamble, they usually go about it like pensioners in a low-stakes card game. “Should we lower interest rates, or stand pat? Let's try a quarter-point and hope for the best.” But that, apparently, is not how it works in Tokyo, where the Bank of Japan has recently decided to go for broke. The central bank is not, as many have long been urging, placing its bet on an all-out monetary stimulus. Rather, as its officials made clear this week, the bank's preferred game of chance is politics. The stakes: all that remains of its credibility.

After its surprise announcement last week that it will begin buying equities from the portfolios of the country's ailing banks, the common reaction was that the Bank of Japan had caved in to political pressure by giving succour to banks and their over-protective regulators. Waves of condemnation followed, including, on September 20th, an unprecedented shortfall of bidders at the Ministry of Finance's auction of ten-year Japanese government bonds. In response to the criticism, officials at the central bank have begun privately pressing their case. Their explanation is even more stunning than their original decision.

By taking such an unorthodox step, says one senior official, the Bank of Japan hopes to act as a “catalyst” in order to “ignite full-fledged efforts among related parties to deal with the [banks' bad-loan] problem.” Although he admitted that there had been political pressure, “explicit and implicit”, to buy the shares, the official maintains that this was not the reason for the new policy. The Bank of Japan is trying to take the game to the rest of Japan's government, goes his argument, not the other way round. It is an independent decision, he says, “based on our serious concern about the state of the financial system... We are not 100% sure that this approach will work. It's a big gamble.”

Another senior official was similarly blunt, saying that the timing of the Bank's decision was tied directly to Japan's political cycle. An upcoming reshuffle of Junichiro Koizumi's cabinet; the prime minister's rising poll numbers; and rumours that he was growing fed up with Hakuo Yanagisawa, who heads the Financial Services Agency (FSA), the banks' regulator: all this led some central-bank officials to conclude that the odds of Mr Koizumi taking serious steps to restructure bad loans had gone up, and that its extraordinary new policy might push him in the right direction.

With arguments still going on inside the Bank, it is clear that different officials had different reasons for backing the plan, which it was apparently considering weeks in advance. Some, certainly, were concerned that falling stockmarkets risk destabilising the banks, which hold massive equity portfolios that are riddled with losses. With politicians clamouring for the central bank to buy shares, the scheduled replacement next spring of Masaru Hayami, the Bank's governor, also weighed on a few officials' minds. Their calculation seems to have been that it was better to act now, in a fashion that met politicians' approval, than to have an outsider foisted on them. Mr Koizumi has a penchant for appointing private-sector folk to head up public institutions.

Little to date is sure about the share-buying proposals, other than that they will be small—around ¥1 trillion-3 trillion ($8 billion-24 billion). Indeed, when you compare the surprising break from central-bank orthodoxy with the likely limited impact of the scheme, it does seem more geared towards getting people's attention, and thus allowing the central bank to broadcast its argument. And the argument,

quite simply, is that the FSA is failing to deal with the banks' bad loans, amounting probably to ¥150 trillion.

The FSA, just as vehemently, has said that bad loans will soon be coming down nicely, and that better monetary policy would help. The Bank's new contribution to this debate goes something like this: “By doing something that any good central banker would consider nuts, we are showing the prime minister how firmly we believe we are right.”

Since they could achieve the same thing by setting their building on fire, why go about it this way? By helping to provide a cushion for banks' share sales, say people at the Bank of Japan, it is providing stability and making it easier for Mr Koizumi to choose decisive action. Unfortunately, the flaw in this argument is that, by the same reasoning, the Bank is also lowering the short-term cost of the government doing nothing about the banks. Every deck in Japan is stacked in favour of muddling through, so the Bank of Japan's gamble thus seems irrationally exuberant. Now that the bet has been taken, the best onlookers can do is hope that it somehow beats the odds.

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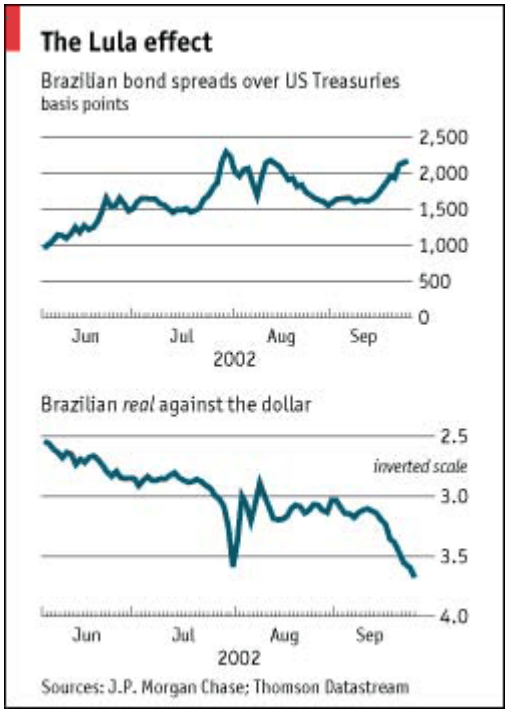
Brazil

Race against time

Sep 26th 2002 | SAO PAULO
From The Economist print edition

The markets are nervous about October's presidential election



BRAZIL'S *real* fell to an all-time low this week, dragging other Latin American currencies down with it, as Luiz Inacio Lula da Silva of the left-wing Workers' Party maintained a strong lead in the polls before the presidential election on October 6th. Mr da Silva is making great efforts to present himself as a centrist: he now pledges to honour Brazil's debts, not renege on them. The markets are unimpressed, fearing he may quickly lose control of the country's precarious finances.

In August a $30 billion package of aid from the International Monetary Fund was intended to soothe Brazil's election jitters. Yet as Mr da Silva has extended his lead, the *real* has fallen further—September 24th's record low of 3.78 to the dollar means it has lost almost 40% of its value this year. After the IMF deal was announced, the risk premium on Brazil's bonds—their yield above American Treasury bonds—recovered from 2,294 basis points (22.9 percentage points) to 1,687. This week the risk premium jumped back above 2,100.

The government mostly pays interest on its bonds linked either to the exchange rate or to the high interest rates set by the central bank, so the debt has ballooned. In July, government debt hit an unprecedented 62% of GDP, up from 53% a year earlier. August's aid relief brought the ratio down a few points, but this week's fall of the *real* is likely to push it to a fresh record.

The government has tried to stabilise the debt by running ever greater primary surpluses on the budget (ie, before interest payments). And, at the insistence of the IMF, Mr da Silva and the other main candidates promised to maintain a budget surplus of at least 3.75% of GDP next year. Still, the further the currency sinks, and the higher are the rates that investors demand for rolling over the debt, the bigger is the surplus needed to stabilise the debt ratio. Recent studies conclude that unless market conditions improve soon, Brazil's debt burden may become unbearable.

The government has some cash in hand and should get $6 billion of the IMF loan by the end of the year—the rest will come during 2003. Graham Stock, J.P. Morgan Chase's regional strategist, thinks that the government has enough cash to survive until about Christmas, even if the bond markets stop rolling over any expiring government debt. However, the government has heavy debt expiries early next year, so if market turbulence continues the situation could get grave.

In other words, if he does win, either outright on October 6th or in a second round of voting three weeks later, Mr da Silva will have only a short time to establish his credibility. There is plenty he could do. First, he could announce credible inflation targets. His advisers hint at a slight loosening of next year's central target, currently 4%. But by how much? He could copy Tony Blair's bold move on coming to power in Britain in 1997, and grant the central bank independence. Mr da Silva's aides do not rule this out. Rapid action to push through other urgent reforms—for example, of the deficit-ridden state pension scheme—would also impress the markets.

Mr Blair reassured investors by keeping on the governor of the Bank of England, Sir Edward George. Mr da Silva has dismayed markets by saying that Arminio Fraga, Brazil's trusted central-bank chief, must

go. His advisers are less adamant, however, when asked if Mr Fraga might stay on a few months to help with the transition. This would be reassuring, as would be the appointment of a finance minister trusted by the financial markets—the Workers' Party has no such figure and would have to seek an outsider.

In his 1997 campaign, Mr Blair repeatedly promised to stick to the then Conservative government's spending plans for the coming two years. Mr da Silva, likewise, could keep reiterating a recent pledge to maintain a sufficient primary surplus to stabilise the government-debt ratio. Mr Blair swept to power with a crushing parliamentary majority (including many “New Labour” moderates), whereas Mr da Silva would have to seek a coalition, preferably a centrist one including some parties currently in the governing block. This would reassure markets that the unreformed lefties on the benches of the Workers' Party will not hold him to ransom.

Brazil's banks are much stronger than Argentina's were before that country's default in December 2001 and its resulting banking collapse. Argentina's problem was that bank deposits and loans were largely dollarised, creating huge problems when its currency sank. That is not the case in Brazil. Nevertheless, says Victoria Miles, bank analyst at J.P. Morgan Chase, Brazilian banks have about 30% of their total assets (or 300% of their net worth) in government bonds. A forced restructuring of Brazil's debt is still avoidable, she believes. But if it happened, the banking sector would face a “high level of stress”.

In other words, Mr da Silva must realise how enormous would be the economic and political price of letting Brazil slide into default. To save the financial system in the event of a default, some sort of Argentine-style deposit freeze might be needed. Brazilians would never forgive him for that. If Mr da Silva wants to be sure of avoiding such a fate, he must act fast and he must act convincingly.

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Investment banking in America

Unburdening

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Success on Wall Street has come to mean cutting people and problems

NO INVESTMENT bank has actually gone bust of late, and even disappointing results for the third quarter, announced over the past two weeks, show that most of the big firms nevertheless have returns on equity in double digits, or very nearly. Solace, presumably, to those still at their desk as colleagues are turned out on the street.

Still, panicky investors have pushed the shares of every major bank to their lowest level in years as they have watched falling stockmarkets, the thinnest of pickings for both mergers and acquisitions and the underwriting of new shares, and now the growing mass of litigation surrounding investment banks. Even the shares of Goldman Sachs, which likes to think of itself as being in a class above the rest, have dropped below the price on the day of Goldman's initial public offering in 1999.

Over the past year, costs at the eight biggest Wall Street firms have fallen by one-fifth, or $4.3 billion. In New York, 20,000 jobs in the securities industry have been lost, a tenth of the total. The same number again will need to go in order to match post-bubble reality, says Svilen Ivanov of the Boston Consulting Group. Even the few investment banks that are not cutting their numbers, such as UBS Warburg, are nevertheless getting rid of dull performers, to replace them with those they expect to be more stellar. Meanwhile, out go fancy dinners and even, heavens, business-class flights.

In New York, 20,000 jobs in the securities industry have been lost. The same number again will need to go in order to match post-bubble reality

If there was a surprise in the latest batch of results, it was the sharp jump in earnings posted by Goldman, which managed to increase profits by 12%. Yet because the source of these earnings is buried deep within the bank's proprietary-trading operations, the numbers have been viewed more with bewilderment than admiration. The top prize for performance goes to Bear Stearns, a grittier firm which managed to post quarterly earnings up 22% while revenues fell by 4%.

Bear Stearns's recipe? A strong market for mortgages, a speciality, helped. So did higher earnings from brokerage operations that cater to hedge funds, another house strength. Such funds have held big short positions as stockmarkets have slumped. Bear Stearns earns money from lending the funds shares to sell.

The firm also benefited simply because it never was a force in mergers and acquisitions or offerings, to which so many others committed huge resources. Yet perhaps the biggest reason for Bear Stearns's success is that it began a determined cost-cutting drive a year ago, when many firms held out hope of a quick recovery. Others have since got the message.

Most investment banks feel that even if they cut staff too far, they can always rehire if business picks up. Weighing more uncertainly is the fear of litigation. Citigroup, for instance, is being scrutinised by the Securities and Exchange Commission, New York's attorney-general, the Justice Department, Congress and Manhattan's district attorney—among others.

Last week, the National Association of Securities Dealers (NASD) announced that it was imposing a $5m fine on Citigroup's Salomon Smith Barney subsidiary, for publicly hyping Winstar, a telecoms company, at the same time as it was privately urging others to sell. Winstar is now bankrupt. Were the settlement the end of Citigroup's problems, Winstar would not have been such a bad transaction. According to the NASD, Salomon Smith Barney received $24m for underwriting $5.6 billion-worth of Winstar securities. Investors might have lost buckets, but Citi still looks $19m ahead after the fine.

As part of the announcement, however, the NASD helpfully mentioned other, “larger” investigations into the bank's vilified research—by itself and by other regulators. At what point does Citi's reputation begin to crumble? Even if the litigation can be settled, the attention of senior management has shifted from running the business to defending it.

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Credit Suisse

Twin peaks

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Are two new bosses better than one?

LUKAS MÜHLEMANN may have been deposed only last week as head of Credit Suisse, Switzerland's second-biggest financial group. Yet he had been weakened at least since last year, when he forced out a Credit Suisse veteran, Oswald Grübel, head of private banking, and replaced him with Thomas Wellauer, a pal from his days at McKinsey. Mr Mühlemann then fired his protégé and called back Mr Grübel when he needed a scapegoat for the group's troubles. The only surprise is that news of Mr Mühlemann's departure did not come sooner.

Mr Mühlemann leaves an unenviable legacy. Five years ago, as an enthusiastic believer in *Allfinanz*, the notion of providing a one-stop shop for insurance and banking services, he bought Winterthur, Switzerland's biggest non-life insurer. Winterthur's capital strength certainly helped the group in the wake of Russia's financial crisis in 1998. But in June this year SFr 1.7 billion ($1.1 billion) had to be pumped into a much weakened Winterthur. Mr Mühlemann also led the takeover of Donaldson Lufkin & Jenrette (DLJ), an American securities firm, in 2000—the start of a vicious bear market. More than half of DLJ's staff have since gone. The entire investment-banking arm, CSFB, is surely worth less than the $12 billion paid for DLJ alone.

The new management structure is less than perfect. Walter Kielholz, the chief executive of Swiss Re, a reinsurer, is the new chairman; he never wanted the job. The role of chief executive is to be shared by John Mack, head of CSFB, and Mr Grübel, who runs Credit Suisse Financial Services, which includes Winterthur. Mr Mack backed Mr Mühlemann when he sacked Mr Grübel.

A takeover of Credit Suisse, even in part, might be desirable, yet it is unlikely. What foreigner would want to buy Winterthur with its financial black hole? Competition authorities would probably block rival Swiss insurers. As for CSFB, Deutsche Bank, for one, needs to beef up its investment banking, but it denies any interest. No wonder: its shares would plummet. Bank of America appears to have ruled out buying CSFB, given that firm's troubles with American regulators. If Rainer Gut, still a power in the background at Credit Suisse, has his way, the group will never sell the investment bank that he pushed into the top league on Wall Street.

Despite the potential for power struggles, Mr Kielholz insists that the management overhaul is not a temporary arrangement. He is expected to give up his job at Swiss Re at the end of the year in order to take on the Credit Suisse chairmanship full-time. Meanwhile, the intention is to give more autonomy to the group's investment-banking arm and to Winterthur.

Mr Mack and Mr Grübel have a gargantuan task in reviving the fortunes of their respective businesses. Since he took charge in July last year, Mr Mack has laid off 3,000-odd bankers and slashed costs by $2 billion. He is now working through the bank's pile of bad debts. CSFB took on excessive credit risk in the hope of generating investment-banking revenues, says David Williams at Morgan Stanley. Mr Grübel will have to take care of an ailing insurer as well as all of the group's retail and private banking. Perhaps the two new top dogs will simply not have much time to fight.

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Economics focus

First will be last

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Internet economics has proved a bit of a disappointment

IN THE late 1990s, firms bet billions of dollars on a theory that turned out to be wrong. It said that in e-commerce, what mattered most was being first. Don't worry about being best, if that slows you down. Sell your product at a loss, give it away, pay people to take it: just build your base of customers fast. Why? Because the weird economics of the Internet—network effects, enhanced economies of scale and lock-in—gave a decisive advantage to first-movers.

Now that something approaching 100% of the Internet economy's first-movers have gone bust, this theory looks less plausible. Yet the logic once seemed persuasive. Where exactly did Internet economics go wrong? A new book by Stan Liebowitz, a professor of economics at the University of Texas at Dallas, and a long-time sceptic of the view that the Internet changes all the rules, gives the most thorough answer so far. “Re-Thinking the Network Economy”* explains what the Internet did change and what it did not, so far as economics is concerned—and it does so in a witty and accessible way. It is the best book to date on the fallacies of the e-commerce craze.

Mr Liebowitz covers a lot of issues: the exaggerated advantages of Internet retailing over conventional retailing; the false claim that the Internet's lower costs would give Internet firms bigger profits; the inadequacies of the broadcast-television model of advertising revenues; the poorly understood questions of copyright and digital-rights management. But the crux of the book is two chapters devoted to attacking the theory of lock-in. This was the notion that caused the biggest mistakes—and the area where many economists were most at fault.

They just didn't get it

As the story was told, Internet lock-in happens largely because of network effects. When the value of a product to consumers increases with the popularity of the product, that is a network effect. (A telephone is worthless if you own the only one; the wider the network, the more useful a phone becomes.) Given strong network effects, a company that gains a big share of the market will be protected from competition from late-movers. Even a plainly better product may fail, because people, much as they may prefer it in itself, will wait for others to buy it first. The implication for business is that moving first is all-important.

In refuting this, Mr Liebowitz emphasises the distinction between two kinds of lock-in. The question of compatibility is central to both. One kind of lock-in arises simply because switching to a new product involves a cost beyond the purchase price: costs of learning how to use it, for instance, or the difficulty of using it alongside products you already own. Mr Liebowitz calls this self-incompatibility, or weak lock-in. But there is also strong lock-in. This arises if a new product is incompatible with the choices of other consumers—and if, because of network effects, this external incompatibility reduces the value of the product.

The point is that weak lock-in is very common, indeed pervasive. Many new products have to overcome self-incompatibility. People do not buy a new computer every three months even though the product is improving all the time. Learning to use a new word processor is a bore; for most users, a rival has to be much better, not merely a bit better, to be worth the trouble. Note that if slightly better products are rejected because of self-incompatibility, this is not inefficient: it would be inefficient to buy such a product, incurring all the costs, unless the improvement was big enough to justify it. To repeat, weak lock-in is nothing new.

Strong lock-in is different, because of the network aspect. Strong lock-in means that consumers won't move to a new and much better product unless a lot of others jump first. If they could somehow agree to move together, they would all be better off. But they cannot. Strong lock-in reflects a failure of co-ordination, it causes economic losses, and in theory it does create opportunities for decisive first-mover advantage. But how common is it, even in the new economy? Mr Liebowitz is forthright on this. Strong lock-in is not merely uncommon, he says, there is actually no known instance.

The lock-in literature leans heavily on just two examples: the persistence of the supposedly inferior QWERTY keyboard (see article) and the triumph of the VHS video standard over the supposedly superior Betamax. Both examples, Mr Liebowitz shows, turn out to be bogus. The QWERTY keyboard is about as fast to use as the most plausible alternatives, and VHS had important non-network advantages over Betamax—notably, longer tapes. Neither case shows strong lock-in.

Name a plainly superior technology that society has set aside not because of private cost or self-incompatibility, but because wide adoption was a precondition for its success. Not easy. Network effects do exist, and in principle they could work as the advocates of strong lock-in say, but in practice they have turned out to be far milder than e-commerce zealots supposed—in case after case, too weak to suppress plainly superior products.

Long before the Internet, consumers had plenty of experience adopting better technologies despite network-effect obstacles: cars (you need petrol stations), telephones, fax machines and, most recently, generation upon rapidly succeeding generation of network-dependent consumer-electronics devices. If a new product offers a clear margin of improvement over a competing one, consumers not only want to take it up themselves, they expect others to do the same. In this way, even where network effects apply, a sufficient margin of improvement achieves the necessary co-ordination among consumers.

In short, quality matters. Even in industries where the winner takes all (also rarer than you might think), having the best product matters more than being first to market. That may be old economics, but keeping it in mind would have saved a lot of people a lot of money.

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Scientific fraud

Outside the Bell curve

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A major scientific fraud has just been confirmed

AP

THE sound of swallowed pride is rare but welcome. Bell Laboratories, one of the most venerable names in science, the home of the transistor and currently the research arm of Lucent Technologies, is prouder than many. But it has been taken for an enormous ride, and on September 25th it had the grace to admit it.

That was the day that a report into the activities of Jan Hendrik Schön, one of the laboratory's highest-flying physicists, was released. Dr Schön has spent the past few years turning out results of a quantity and apparent quality that were, until a few months ago, universally acknowledged to be worthy of a Nobel prize. Unfortunately, he seems to have made them up.

Moreover, he did so in a surprisingly artless way. Though suspicions were aroused when other labs could not duplicate them, these suspicions were generally explained as the result of differences in equipment. Indeed, the fact that Dr Schön could, by his own admission, achieve some findings only 10% of the time helped to allay people's fears. It began to look as if a quirk of his kit might be responsible, and the search turned to what that quirk might be. What caught him out in the end was that he used identical (though differently labelled) graphs to illustrate papers in fields as diverse as the physics of semiconductors and superconductors.

When that emerged in May, Bell Labs immediately formed a committee of independent scientists, under the chairmanship of Malcolm Beasley, a respected physicist from Stanford University, to investigate what had happened. It is their report that has just been published.

What a tangled web we weave

Semiconductivity and superconductivity are critical to electronics. Dr Schön began his career looking at semiconductors made not of silicon (the preferred material for most commercial applications), but of organic molecules. In chemical parlance an organic molecule need not necessarily have come from a living creature. The term refers to molecules (often quite complex ones) that are built around a skeleton of interlinked carbon atoms.

Materials made of organic molecules are often flexible (plastics are organics). They are often cheap to manufacture too. But although signs of semiconductivity had been observed in a group of organic molecules called pentacenes, no one had been able to use them to build actual semiconducting devices, such as transistors.

So when Dr Schön announced, in 2000, that he was able to make transistors out of pentacene, and then went on to demonstrate a number of abstruse semiconducting phenomena, such as the quantum Hall effect, in his pentacenes, everybody sat up and took notice.

He then capped this work by taking buckminsterfullerene, another organic molecule (also known as a buckyball because it has the shape of a miniature soccer ball), and, so he claimed, turning it into a superconductor. Not any old superconductor either. His bucky-superconductors worked at surprisingly

high temperatures.

Superconductors (so called because they conduct electricity without resistance) work only below a certain, critical temperature. For the original superconductors, discovered almost a century ago, that temperature was so close to absolute zero that commercialisation was very restricted. In the late 1980s, it was found that some materials called perovskites would superconduct at temperatures higher than 77° above absolute zero. That meant they could be cooled with liquid nitrogen, which is cheap. Perovskites, however, are difficult to fabricate, so commercial applications were still limited.

Dr Schön's first bucky-superconductor “worked” at 11° above absolute zero. Through a carefully staged set of “improvements” to the technique, he got this up to 117°—well into the liquid nitrogen zone. Buckyballs are a discovery looking for an application, and it seemed as though Dr Schön alone had found one.

And that last sentence holds the key to the fraud. For modern science is generally a collaborative effort. All of Dr Schön's 90 papers had co-authors—people who should, if things had worked the way they are supposed to, have been able to vouch for the quality of the research. But in practice, Dr Schön was actually working by himself. As the Beasley inquiry report puts it: “None of the most significant physical results was witnessed by any co-author or other colleague.” That did not stop them putting their names to the work, though.

It did not stop the report exonerating all the co-authors either: “The committee does not endorse the view that each co-author is responsible for the entirety of a collaborative endeavour.” In other words, where more than one person might carry the can, nobody shall be to blame. Except, of course, Dr Schön. But he is no scapegoat. The fraud was his responsibility. So are the millions of dollars that have been wasted following his “results” up. He will never work in science again.

20:20 hindsight

Mistakes happen. The important thing is to learn from them. There are probably two lessons to learn from this sordid episode. The first, in case anybody had forgotten, is that scientists are humans too. Some of them will do stupid and mendacious things. The second, and more important lesson, is that you can't cheat nature.

There will probably be a lot of finger-pointing at the system of peer review, in which journals send papers out to independent experts to be evaluated. Some scrutiny of the peer-review process might be welcome. In this case the results were so exciting that critical faculties may, on occasion, have been suspended. Indeed, several people have commented in retrospect that the results were too good. They matched theory exactly, which is unlikely both because experiments and theory are rarely in perfect agreement—particularly with preliminary work—and because the theories were developed for inorganic semiconductors such as silicon. It really would be a surprise if organic semiconductors were to behave in exactly the same way as inorganic ones.

The harshest examiner, however, is not a scientist's peers, but reality itself. The more significant a result is, the more it will be tested by that reality. In the case of Dr Schön's results, several of which had technologists licking their lips in anticipation of the inventions that might flow from them, the reality test was going to be enormous. How he expected to get away with it is mysterious. So, perhaps there is a third lesson as well. If you do cheat at science, do so in a field which is so insignificant that no one will bother to check.

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Diesel engines

Hybrid vigour

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A small electric motor can boost the performance of a diesel

BETWEEN the fuel cells that will power the cars of the future and today's petrol and diesel engines lie hybrid internal-combustion/electric vehicles. No one now believes that battery-driven electric cars will take over: the batteries are too heavy and run down too quickly. But cars that get their electricity from an internal-combustion engine acting as a generator are a reality. Two such hybrid vehicles, the Toyota Prius and the Honda Insight, are already selling in America and Japan. However, they cost about $3,500 more than normal models, and weigh more than conventionally powered cars.

The trouble is that having two propulsion systems doubles the engine weight. In addition, there is a need for extra equipment to control the way that the two systems interact, and such control electronics are notoriously heavy. Ricardo, an engine consultancy based in southern England, has just unveiled a hybrid car which addresses these problems. Working with Valeo, a leading French car-parts maker, it has started with a conventional two-litre diesel-powered Opel Astra and converted it to hybrid propulsion.

The Astra produced 100 horsepower, but Ricardo was able to get the same output by fitting a lighter 1.2 litre turbo-diesel, that had state-of-the-art technology such as “common-rail” fuel injection, variable valve geometry and a turbo-charger. That improved efficiency. But there was one disadvantage—a lack of torque (pulling power) at low engine revs. Which is where the electric drive comes in. In an arrangement that it calls “mild hybridisation”, Ricardo has rigged up an electric motor that delivers extra power (6kW at 42 volts) if the engine is turning over at less than 2,000 revolutions per minute. This allows the car to accelerate as rapidly as the original, but its fuel consumption is 20% less.

The Ricardo/Valeo prototype uses a number of tricks to reduce weight. The principal one is that the diesel engine's flywheel is wrapped with wiring, allowing it to double up as the core of the electric motor. In addition, the choice of a 42-volt output means that all the car's requirements for ancillary power—for the cooling fan, air conditioning, lights and so on—can be provided by this generator. There is therefore no need for the diesel to have its own alternator-driven electrical system, a significant weight saving.

Fuel consumption is a thrifty four litres per 100km (70 miles per gallon) and emissions of carbon dioxide (CO{-2}) are claimed to be between 30% and 35% lower than the pure diesel version—a useful consideration given that European car producers are committed to a 25% reduction in CO{-2} emissions across their car fleets by 2004.

Indeed, Europe is seen as the main market for the Ricardo/Valeo concept. The demonstration vehicle has been shown to the bosses of all the leading car companies. For them, the principal attraction of such a system is that the mild hybrid should cost only about $1,000 more to make than a conventional vehicle.

The motor industry more or less agrees that hybrids are the next big thing. The only question is how to get the best out of them without adding too much weight or complexity. The Ricardo/Valeo idea of a miniaturised diesel engine is an ingenious step forward. Even in America, where nobody cares much about CO{-2} emissions, hybrids are viewed as a way of reducing the huge thirst of big sport utility vehicles. The idea being considered by manufacturers there is to have an electric motor driving two wheels and a petrol engine driving the other two. If the systems can be made to work in harmony, there could be great savings just down the road.

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Strokes and heart attacks

An inside job

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Some new ways of preventing dangerous blood clots

CURRENT estimates suggest that half of the people living in North America and Europe will die from a blood clot in a vital organ such as the heart, the brain or a lung. Preventing clots is therefore an important goal, and two recent advances have brought that goal nearer.

Athan Kuliopulos, of the New England Medical Centre in Boston, and his colleagues have focused on cellular receptors. Body cells bristle with receptor molecules that react to chemical messages from elsewhere. If these receptors are blocked, the cell does not know what is happening in the outside world, and so does not react.

Many drugs work by blocking receptors. In particular, more than 50% of prescription drugs stick to a group of molecules known as G-protein-coupled receptors (GPCRs). There are more than 1,000 types of human GPCR. Two of them are responsible for deciding when platelets—the cellular fragments that create blood clots—should stick together to form such a clot. Blocking these two receptors should prevent clotting. Doing so, though, has proved an intractable problem.

Dr Kuliopulos decided that if he could not block them on the outside of the cell's external membrane (the traditional way of doing these things), he would, as it were, go through the back door and block them on the inside of the membrane. The trick was to get the blocking agent—a fragment of protein known as a peptide—across that membrane. He achieved this by attaching the peptide to a molecule made of the same stuff as cell membranes. The result was a combined molecule, called a pepducin, that partially dissolves in cell membranes, and thus can penetrate them.

The new agent will have to go through many years of testing before it can hope to become a drug. But Dr Kuliopulos says that experiments in mice and on human blood cells—described in this month's *Nature Medicine*—have shown that his pepducin blocks both of the relevant platelet GPCRs. It therefore has the hallmarks of a powerful anti-clotting agent.

Although there are many existing anti-coagulants, none is perfect. Pepducins may be able to help the 5-7% of patients who react adversely, or not at all, to existing ones. Blocking the receptors on the inside of the cell in this way also turns out to be a completely novel method of disabling GPCRs. So the researchers think that pepducins have potential as drugs affecting other GPCRs, and thus other diseases.

Preventing platelets from clotting is just one means of preventing blockages from forming inside blood vessels. Another is to stop those vessels becoming inflamed, and thus being susceptible to such blockage in the first place. In an article in the current issue of *Stroke*, John Hallenbeck, of America's National Institute of Neurological Disorders and Stroke, and his colleagues showed that they could vaccinate against the sort of inflammation that constricts blood vessels, thereby reducing the frequency and severity of strokes in experimental animals. They did this by interfering with a protein called E-selectin, which contributes to inflammation. By exposing rats to E-selectin, they were able to provoke an immune response to this protein. That meant that the rats produced antibodies against E-selectin when blood-vessel cells started to turn it out. The antibodies knocked out the protein and thus suppressed the inflammation.

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Internet connectivity

Making the Web world-wide

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A project in Laos is giving Internet access to villagers without electricity

EPA

Modern technology, anybody?

"THE creation of the PC is the best thing that ever happened," said Bill Gates at a conference on "digital dividends" in 2000. He even wondered if it might be possible to make computers for the poor in countries without an electric power grid. The answer is yes, and things are going even further. Villagers in a remote region of Laos that has neither electricity nor telephone connections are being wired up to the Internet.

Lee Thorn, the head of the Jhai Foundation, an American-Lao organisation, has been working for nearly five years in the Hin Heup district. The foundation has helped villagers build schools, install wells and organise a weaving co-operative. But those villagers told Mr Thorn that what they needed most was access to the Internet. To have any hope of meeting that need, in an environment which is both physically harsh and far removed from technical support, Mr Thorn realised that a robust computer was the first requirement.

He therefore turned to engineers working with the Jhai Foundation, who devised a machine that has no moving, and few delicate, parts. Instead of a hard disk, the Jhai PC relies on flash-memory chips to store its data. Its screen is a liquid-crystal display, rather than an energy-guzzling glass cathode-ray tube—an exception to the rule that the components used are old-fashioned, and therefore cheap. (No Pentiums, for example, just a 486-type processor.) Mr Thorn estimates that, built in quantity, each Jhai PC would cost around $400. Furthermore, because of its simplicity, a Jhai PC can be powered by a car battery charged with bicycle cranks—thus removing the need for a connection to the grid.

Wireless Internet cards connect each Jhai PC to a solar-powered hilltop relay station which then passes the signals on to a computer in town that is connected to both the Lao phone system (for local calls) and to the Internet. Meanwhile, the Linux-based software that will run the computers is in the final stages of being "localised" into Lao by a group of expatriates in America.

One thing that the new network will allow villagers to do is decide whether it is worth going to market. Phon Hong, the local market town, is 30km away, so it is worth knowing the price of rice before you set off to sell some there. Links farther afield may allow decisions about growing crops for foreign markets to be taken more sensibly—and help with bargaining when these are sold. And there is also the pleasure of using Internet telephony to talk to relatives who have gone to the capital, Vientiane, or even abroad.

If it works, the Jhai PC and its associated network could be a widespread success. So far, the foundation has had expressions of interest from groups working in Peru, Chile and South Africa. The prototype should be operational in Laos this December and it, or something very much like it, may soon be bridging the digital divide elsewhere as well.

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American politics

Is America moving leftward?

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AP

If you think this sounds like a question from planet Pluto, then read this book

IN 1969, a young conservative activist named Kevin Phillips predicted the emergence of a Republican majority in the United States. It was a bold thing to forecast at the time. Richard Nixon had just won the White House by a narrow margin, only the second Republican to gain the presidency in 36 years.

Seen from today, Mr Phillips's prediction looks pretty good. Republicans have occupied the White House for 21 of the 33 years since he wrote. Had it not been for the Watergate scandal that drove Nixon from office and handed the Democrats victory in 1976 against the mood of the times, the Republicans' run would probably have been even longer.

Now, two years into the presidency of the narrowly elected but currently very popular George Bush, John Judis, a writer at the *New Republic*, and Ruy Teixeira, of the Century Foundation, offer an equally bold but opposite prediction. Working as Mr Phillips did from demographic trends and voting patterns, they foresee an emerging Democratic majority.

The Emerging Democratic Majority
By John B. Judis and Ruy Teixeira

Scribner; 224 pages; $24

Buy it at
Amazon.com
Amazon.co.uk

Their thesis is not entirely original. In 1996 a *Washington Post* columnist, E.J. Dionne Jr, predicted a Democratic and liberal revival in “They Only Look Dead”. Mr Phillips himself in “Wealth and Democracy”, pointed earlier this year to what he believes is an impending crisis for Republican conservatism. This book by Messrs Judis and Teixeira, however, is so crisply clear in its exposition and so skilfully supported by statistical evidence and analysis that it may finally turn conventional wisdom on its head.

Simply put, their thesis is that the conditions which led to the Republican era were over by 1992. Without working-class Reagan Democrats, without moderate suburban Republicans, and above all without California, it was impossible to sustain a durable conservative majority. Since then, the social foundations for a lasting Democratic majority have been properly laid.

That Republicans are still in charge, and may remain so after November, is due, they allow, to Bill Clinton's personal misconduct and to September 11th 2001. But the new majority, they insist, is ripening. They see the shift as bound up with changes that America has undergone in the past 30 years, “from an industrial to a post-industrial society, from a white Protestant to a multi-ethnic, religiously

diverse society...and from a society of geographically distinct city, suburb and country to one of large, sweeping post-industrial metropolises."

The authors move easily from electoral analysis through perceptive observation of sociological change to ambitious but plausible generalisations about the new *Zeitgeist*. They deal politely but robustly with much conventional wisdom. They disagree with the view of an influential centre-right pundit, Michael Barone, that demography, religion and economic trends all favour the Republicans. The big population increases are in places that support the Democrats, they argue. They claim that conservative advocates systematically overestimate how many Americans regularly attend church. And they believe that, whatever may have been true in the 1980s, a majority of Americans strongly oppose laisser-faire policies on pensions and on health care.

The authors do not spell out in a wholly conclusive manner the precise connections between post-industrial change and Democratic revival. Nor are they always careful to distinguish the party contrast, Democrat-Republican, from the ideological distinction, liberal-conservative. Although there are relatively few liberal Republicans, there are plenty of conservative Democrats. It is they, in recent times, who have tended to decide American elections, voting the party ticket when their candidate is dependably right-wing but happily bolting to Republicans when, as in 1972 and 1980, he looks too liberal.

Messrs Judis and Teixeira make no secret of where their sympathies lie, and the predictions in this comprehensive study are also hopes. Conservative readers in particular may jib at some of their more partisan judgments. Indeed, another plausible view is the Floridisation of American politics, the idea that it is now in an exact two-party balance. Nevertheless, all in all, the authors make a persuasive case that something is happening in American politics, and that it is not good news for the Republican Party or for conservativism.

The competence and honesty of corporate chief executives, accountants and stockmarket analysts have been questioned in a way not seen since Richard Whitney, a one-time head of the New York Stock Exchange, defaulted in 1938. White working-class men are returning to old allegiances. Minorities, including most of the fast-growing Hispanic and Asian populations, a large and growing majority of women, and now professionals (even doctors!) are voting Democrat. Events, the authors admit, could still throw their prediction off. In international crises Americans rally to their president, whatever his party. Yet the trend, they insist, is leftward.

The Emerging Democratic Majority.
By John B. Judis and Ruy Teixeira.
Scribner; 224 pages; $24

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About sponsorship

History of science

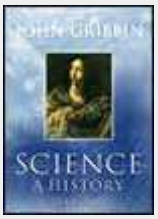
Time's arrow

Sep 26th 2002
From The Economist print edition

MODERN science began when people realised, during the 16th century, that the ancient Greeks had been wrong about almost everything. Trusting their own observations rather than old dogma, the first scientists invented a new way of investigating nature, resulting in a deluge of discoveries that changed the world.

John Gribbin, an astronomer and popular-science writer, begins his sweeping new history of science in 1543, with the publication of two crucial books that helped to kick-start this process. One, Copernicus's “De Revolutionibus Orbium Coelestium” (On the revolutions of the celestial spheres), advocated a heliocentric model of the universe that, with the help of Galileo Galilei, swiftly deposed the flawed physical theories of Aristotle and Ptolemy. The other, Vesalius's “De Humani Corporis Fabrica” (On the fabric of the human body), began the process of turning biology into a science by encouraging hands-on anatomical investigation rather than the hand-waving medical theories of Galen. From these twin starting- points, Mr Gribbin's book follows the history of science along the two resulting strands of enquiry into the physical and life sciences.

Science: A History 1543-2001
By John Gribbin



Penguin/Allen Lane; 672 pages; £25

Buy it at
Amazon.co.uk

This is no mere retread of scientific history's well-worn paths, however. Drawing on the latest scholarship, Mr Gribbin manages to cast new light on old and familiar stories, demolishes innumerable myths, picks apart fact and fiction, and exposes the factual roots of some of science's well- known tales. Though he ridiculed the Aristotelean claim that heavy objects fall faster than lighter ones, for example, Galileo never dropped weights of different sizes from Pisa's leaning tower to prove it; the weights were dropped by Aristoteleans hoping to prove Galileo wrong.

Descartes, Mr Gribbin explains, invented the geometric system that bears his name after watching a fly buzzing around a rectangular room. And Newton's uncharacteristically modest remark that his accomplishments were the result of “standing on the shoulders of giants” is intriguingly revealed as a withering side-swipe at his hunchbacked arch-rival, Robert Hooke, to whom Newton refused to acknowledge any debt. (Mr Gribbin's examination of the complex relationship between Newton, Hooke and Edmond Halley is particularly illuminating.)

There are less familiar faces, too, alongside the usual suspects. As well as his contribution to the rehabilitation of Hooke (whom Newton airbrushed out of scientific history), Mr Gribbin champions Thomas Digges as the inventor of the telescope and bestows the title of “the first scientist” on William Gilbert, whose experimental approach to the investigation of magnetism did much to inspire Galileo.

The two strands of the narrative converge when the connections between them (such as the implications of geology for the age of the earth and the origin of species) intensify. The explanations, particularly in the thorny field of quantum physics, are excellent, and the selection of subject matter skilfully winnows a vast field. Mr Gribbin's prose is confident, and his amusing asides include an explanation of the origins of soda water and the observation that the length of a French nobleman's title was, by and large, inversely proportional to his social standing. The triumphant bringing together of genetics and cosmology in the final chapter is cleverly handled and provides a satisfying, and only slightly contrived, conclusion.

Mr Gribbin's is an unashamedly old-fashioned approach to the history of science. He is generous with biographical information and firmly advocates the view that science progresses by incremental steps rather than revolutions or paradigm shifts. He has no time for trendy post-modern interpretations of science, or the suggestion that scientific theories are merely faddish “social constructions” with no basis in reality. Rubbish, says Mr Gribbin: scientific theories are rooted in truth, and new theories are not

merely different from old ones, but are measurably better. “Science: A History” is a splendid book. The endorsement of the late Roy Porter, Britain's foremost practitioner of the history of science, who died earlier this year, underscores the magnitude of Mr Gribbin's achievement.

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By John Gribbin.
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About sponsorship

Business leaders

Why them?

Sep 26th 2002
From The Economist print edition

OF ALL the reams on the stuff of leadership, some of the more sensible has been written by Warren Bennis. A California-based academic, adviser to American presidents and the bosses of some of the largest corporations in the world, he maintains that leaders are made not born. The gang leader in the playground does not end up running General Electric (or Iraq).

In his most famous book, “Leaders: Strategies for Taking Charge” (1997), Mr Bennis debunked the idea that leadership is relevant only to people at the top of an organisation, be it a nation, an army or a corporation. Anyone who can articulate a goal, then make others believe in it and pursue it, is a leader. The goal can be an outing to Disneyland just as it can be regime change in a distant country.

Now Mr Bennis and Robert Thomas, of Accenture's Institute for Strategic Change, have co-written this slight volume in which they argue that leaders are forged by the way they react to formative moments in their lives (which they call “crucibles”). The book is an extended report on a series of 43 interviews with subjects whom the authors have chosen for their leadership skills. All the subjects are American, many of them widely unknown. Just over half of them are “geezers” (people over 70 years of age), and the rest are “geeks” (under 35).

AP

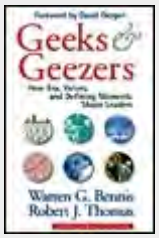
Shakespeare, George Washington and me

The authors have been unable to resist listing the four essential qualities that their research shows these people have brought to their crucibles, and that have made them (we must believe) great leaders. Of the four, the greatest apparently is “adaptive capacity”, something shared by Shakespeare, George Washington and Jack Welch. In the end, it transpires, the four are nothing more than “the same factors that make a person a healthy, fully integrated human being”. Possessed, it is tempting to ask, by people like Napoleon, Winston Churchill and Genghis Khan?

In the context of the current crisis of corporate leadership in America and Europe, the book has disappointingly little to offer. The “adaptive” leaders of Europe's media and telecoms giants are being bundled out in favour of old-school conservatives; while America is tussling with the discovery that, when the goal is the promise of great wealth, followers galore can be corralled and led by almost any semi-numerate adaptive thief. Anyone looking for insight into the behaviour of Kenneth Lay, Bernie Ebbers or Jean-Marie Messier should stick to Niccolo Machiavelli.

Geeks & Geezers: How Era, Values, and Defining Moments Shape Leaders
By Warren G. Bennis and Robert J. Thomas.
Harvard Business School Press; 256 pages; $26.95 and £19.99

Geeks & Geezers: How Era, Values, and Defining Moments Shape Leaders
By Warren G. Bennis and Robert J. Thomas



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Civil war in Sudan

African queen

Sep 26th 2002
From The Economist print edition

EMMA McCUNE was an idealistic young British aid worker who spent much of the late 1980s criss-crossing southern Sudan, then as now in the grip of civil war, dressed in a red mini-skirt. Handing out charity pencils, books and blackboards to outdoor schools financed by a high-minded Canadian lawyer, she cut a striking figure.

What really made McCune's name, though, was her marriage in 1991 to a southern Sudanese warlord, Riek Machar. McCune saw the marriage as a way of breaching the gap between white and black. But to her fellow aid workers, it seemed that she had crossed an invisible, and not altogether happy, line. When the Khartoum government began bombing Sudanese refugees who were fleeing back into the country from Ethiopia, the peaceable aid worker threw herself into Mr Machar's violent quest to take over southern Sudan's rebel movement. In thrall to the man, she paid little attention to the murder and kidnapping that was part of his quest for power. Two years later, McCune was dead, crushed by an itinerant bush taxi near Nairobi. She was 29 and pregnant.

Deborah Scroggins uses the romantic aspects of this beautiful white woman's story to draw in unsuspecting readers. But she has a sharp eye, and her real aim is to tease out the inconsistencies of Emma McCune's brutally short life as a way of looking at how foreigners through the ages have involved themselves in Sudan.

On the road to hell

The humanitarians of the 19th century, many of whom were driven by urges half-hidden even from themselves, have given way to modern famine-relief programmes. The donors who fund them like the idea of giving pencils to small black children. However, they averted their eyes when the hand-made sweaters donated by American knitting circles in the late 1980s proved too warm for the Sudanese (they ended up being worn as decorative hats) and when American food aid was used by the southern Sudanese rebel movement, the SPLA, to maintain scores of camps where kidnapped children were trained to fire guns. They looked away too whenever the Khartoum government felt that foreign aid was making southern leaders like Riek Machar too powerful, and retaliated by bombing feeding stations full of women and their stick-thin children.

American oil companies pay the northern Islamic government to try and gain access to the untapped oilfields that lie in the south of the country. So far, the violence has stopped Chevron and others from getting very far. At the same time, Christian groups in America pour money into financing the southerners against the Muslim north. They believe they are helping to establish a vanguard against the spread of Islam, but what they are really doing is fuelling the civil war. “Emma's War” is about the politics of the belly, and what happens when the fat white paunch meets the swollen stomachs of the hungry in Africa. It is a sorry story, but Ms Scroggins tells it awfully well.

Emma's War: An Aid Worker, a Warlord, Radical Islam, and the Politics of Oil—A True Story of Love and Death in Sudan
By Deborah Scroggins

Pantheon; 389 pages; $25. To be published in Britain by HarperCollins in March 2003

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New American fiction

Pony express

Sep 26th 2002
From The Economist print edition

ADULTERY, mid-life crisis, cattle auctions and the spirit world: Mark Spragg's curiously titled first novel is no ordinary western. Two middle-aged Wyoming buddies, McEban and Bennett, are in love with the same woman, Gretchen, a comely redhead with a satchel full of 17th-century religious verse. Gretchen is married to Bennett, but, as the novel opens, has just leapt into bed with McEban.

McEban is a battered, lugubrious rancher, Bennett a real-estate salesman with a foul temper and a thirst for the demon drink. So it comes as no great surprise when, in chapter three, Gretchen decides to pack her bags and light out for the territories, abandoning both Bennett and McEban for a physicist from Colorado. “When you read this, I'll be gone,” says the note Bennett finds on the kitchen table. “There's another man, but he's only part of the reason. He's the opportunity.” Oddly, though, Gretchen invites Bennett to follow her, apparently in the belief that it will help him to understand why she left him. A further letter, she promises, will be waiting for him at the post office in Bozeman, Montana. Thus the two men set off on an unlikely paperchase across the prairie.

The Fruit of Stone
By Mark Spragg

Riverhead Books; 304 pages; $24.95.
Jonathan Cape; £12

Buy it at
Amazon.com
Amazon.co.uk

Mr Spragg's previous book, a memoir called “Where Rivers Change Direction”, was well received when it appeared in 1999. Readers who liked the richly sensuous way he wrote about the Wyoming landscape in that book will find much to enjoy in “The Fruit of Stone”. But here the fine writing is too hit-and-miss fully to compensate for the wacky storyline, and Mr Spragg lets himself down when he lapses into a sort of sub-Hemingwayesque tough-guy lyricism. A sentence like this one is typical in its slightly awkward combination of plain language and florid tone: “Halfway to the valley floor the sun gains the sky again and the Snake River glows as an uneven rend in the green country below them, and then they're in the little town of Wilson at the bottom of the pass and the smell of their burning brakepads fills the cab and it is fully dawn.” Fully dawn, all right, and—whoa!—time to pull over, cowboy.

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By Mark Spragg.
Riverhead Books; 304 pages; $24.95.
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About sponsorship

Elliott Carter

True notes

Sep 26th 2002
From The Economist print edition

Elliott Carter's composing has never been more creative. And he's 93

THERE are Indian summers and there are Indian summers. There are composers whose creativity continues undimmed through their 70s and 80s; Giuseppe Verdi completed “Falstaff” at the age of 79, Igor Stravinsky was still seeking out new musical discoveries when he was 83. Yet how many are still working well into their 90s? Elliott Carter is one.

A venerated composer, Mr Carter is also one of the most venerable. Mark Twain was telling jokes to the *New York Times* the year Mr Carter was born in the city; in December he will turn 94. Through the decades, Mr Carter has created a musical language that uniquely fuses American iconoclasm and European historicism. Today, he is writing music of dazzling brilliance and subtlety; music that speaks with a playful, and even youthful, directness. His productivity has increased as he has struck out into new fields and forms, pouring forth a stream of pieces from intimate solo works to some of his most ambitious and imposing orchestral scores.

Mr Carter completed his largest-ever orchestral work, a huge triptych, “Symphonia: Sum Fluxae Pretium Spei”, at 88. He wrote his first opera when he was 90. Called “What Next?” and set to words by a British writer and critic, Paul Griffiths, this work about the aftermath of a car crash was premiered by the Berliner Staatsoper in 1999 under Daniel Barenboim.

Undaunted by his advancing years, Mr Carter also has a number of new large-scale commissions planned for the future. This year he is writing two new orchestral pieces, the Boston Concerto for the Boston Symphony Orchestra, and another work for the Chicago Symphony Orchestra. No world-weary swansong, this is an invigorating explosion of creativity.

Early fire

It was while he was still at school that Mr Carter's interest in modern music was fired up by his encounters with Charles Ives, the most radical of the early 20th-century American modernists. In the mid-1920s, the 50-year-old Ives took him to Carnegie Hall and recommended him to the dean of Harvard University. Later, Mr Carter travelled to Paris to refine his technique with Nadia Boulanger. He tried hard to assimilate the teaching of this legendary pedagogue and fountainhead of European neo-classicism into his musical aesthetic. But when he returned to America in 1936, Mr Carter became aware that despite, or perhaps because of these daunting influences, he still had not found his true compositional voice.

The struggle that ensued would isolate him from composers like Aaron Copland and Roy Harris, whose artful simplicity appealed so directly to audiences in New- Deal America. Mr Carter's own voice did not crystallise until he was in his 40s, in the intensely dramatic Cello Sonata, completed in 1948, and even more startlingly in his First String Quartet of 1951. The quartet was composed during a year spent in the deserts of Arizona. This was not merely a physical separation from urban America, but an artistic one, too: a symbol of Mr Carter's rejection of his previous musical life, and the pervasive populism of post-war America.

The first quartet is a vast and unashamedly complex work, as rewarding as it is demanding for both players and listeners. Yet Mr Carter's music of the 1960s and 1970s surpasses even this piece in richness and range. Igor Stravinsky paid Mr Carter's 1961 Double Concerto an underhand compliment, hailing it as “a masterpiece, and by an American composer”.

The Concerto for Orchestra, composed in 1969 for Leonard Bernstein and the New York Philharmonic

Orchestra, is an essay in musical multivalence. The orchestra is divided into four groups, and their music progresses at different speeds simultaneously. The music is in a constant state of becoming, a metaphor for the ceaseless activity that Mr Carter observed in contemporary America. And the effect, of a whirling sonic tempest, turns the piece into a dazzling feat of poetic and technical virtuosity.

Over the past two decades, Mr Carter has refined this language. Many of the same concerns are there: an emphasis on tempo as well as harmony as a structural force, a laser-like ear for instrumental colour, and above all, the creation of a vivid depth of experience for performers and listeners. But there is an even wider expressive range in his recent works, which encompasses lightness and humour as well as power and seriousness. The Asko Concerto, composed in 2000 for the 16 players of the Dutch Asko Ensemble, is a contemporary *concerto grosso*, in which all of the players have their moment in the spotlight. Mr Carter has said that he wanted to create instrumental combinations that would be “fantastical and humorous”, so the clarinet is paired with the double bass, the violin with the trumpet. The work closes with an outrageous bassoon solo, as free and jocular as anything in the repertoire.

Mr Carter is now able to mine the seam of musical material he discovered in earlier decades. He has created a language of uncompromising modernist integrity that embraces an intellectual spectrum from light-heartedness to profundity. It's a rich reward—for both the composer and his audiences—after the years of struggle. “Composition was at one time a matter of rejecting a lot of things I knew”, he says, “and finally finding what I really liked most, and once I'd found that, it was easier to compose.” It's a seam that shows no signs of being depleted.

Mr Carter hopes to enter a second century of composition with unlimited horizons, an achievement almost without parallel in the history of 20th and 21st-century art. The Latin subtitle of his Symphonia is taken from a 17th-century poem by Richard Crashaw, and translates as “I am the prize of flowing hope”. It could stand as a motto for all the composer's recent music, every note of which is a prize won from 80 years of continuous creativity.

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About sponsorship

Joan Littlewood

Sep 26th 2002
From The Economist print edition

Joan Maud Littlewood, a theatrical prodigy, died on September 20th, aged 87

Observer/Jane Bown

MENTION Joan Littlewood and those that still remember her may murmur, “Oh! What a Lovely War” and perhaps hum a few notes of its theme tune. The play was first put on in 1963 and some 40 years later remains a powerful snub to the propaganda of war. It has had a world-wide audience. Not only was it seen in theatres in London, elsewhere in Europe and in the United States, but it was made into a film that reached the millions who never go to a theatre.

Its strength was that it was hugely entertaining, featuring the immensely tuneful songs of the first world war. But just as a nostalgic number was captivating its audience, a news flash would read, “Battle of the Somme ends. Casualties, 1,332,000. Gain, nil.” The play spared no one, especially those in command. A British general prays, “Well, God, the prospects for a successful attack are now ideal...And I ask for victory, oh Lord, before the Americans arrive.” The anti-war feeling of the 1960s that Miss Littlewood captured has endured, and the task of the war propagandist has never been harder.

“How I loathed those songs,” Miss Littlewood said. They recalled a childhood of “photos of dead soldiers in silver frames, medals in a forgotten drawer”. But she also loathed the commercial success of the play, and of other plays she conceived and produced that went on to make heaps of money. Many ordinary mortals would be delighted that a production that started life in a tiny theatre had gone on to do well. But Miss Littlewood was not ordinary and to her admirers there was something a bit immortal about her as well.

It wasn't the money she objected to: for much of her life she was hard up, and many of the plays she produced were put on with little money. What she feared was that her work would be tainted by its connection with conventional theatre. She once said that Laurence Olivier was “the most stupid ham that ever conned people into taking him for an actor”. She dismissed a young Michael Caine with her gravest insult: “You will only ever be a star.” Noel Coward's “Private Lives” was the sort of play she couldn't stand. Understandably, many in conventional theatre didn't much care for her either.

Street theatre

At the start of her autobiography, “Joan's Book”, Miss Littlewood describes a childhood of poverty in London and how at the age of six she was a bridesmaid when her mother finally married. But prodigies have a way of surviving unpromising beginnings. A church school and the local public library provided her with the rudiments of education. At 16 she won a free place to Britain's leading acting school, the Royal Academy of Dramatic Art. In 1934, when she was 20, she joined a company called Theatre of Action, founded by Ewan MacColl, a folk singer she later married. It performed in the streets of Manchester and was one of several dozen such troupes in the north of England.

They modelled themselves on German theatrical troupes which were parodying the recently-installed Nazi government, and whose members would soon be rounded up and sent to concentration camps. Miss Littlewood's plans for a “people's theatre” stem from this time. Bertold Brecht, a German dramatist, was one of her heroes. In “Oh! What a Lovely War” there are echoes of Brecht's “The Threepenny Opera”, of 1928, with its film clips and messages on cards. But revolution had to be put on hold during the second world war, when Miss Littlewood worked for the BBC, making a soap for transmission to American listeners called “Front Line Family”. It was about “everyday people” and at the BBC “I was the only one who'd had contact with such glamorous creatures.”

After the war, bursting with ideas and with a new husband, Gerry Raffles, nine years her junior, whom she had met when he was a teenager, Miss Littlewood once again set out to show ordinary people the magic of theatre. The trouble was, ordinary people were not much interested. “There was an audience for us somewhere, but where?” she said indignantly. In 1953 she and Raffles rented and later bought a once-graceful but now dilapidated theatre in Stratford, not on Avon but in rundown east London. Surely the locals would support the revival of one of their old playhouses, proudly called the Theatre Royal? They did not.

But her company did become famous abroad. It toured throughout Europe. Three plays the company did at a Paris festival in 1955 won rave reviews in French newspapers. The Stratford theatre was “discovered” by London critics and its seats were soon filled by middle-class people. They tolerated the classics, such as Ben Jonson's “Volpone”, and loved musical productions such as “Fings Ain't Wot They Used T'Be”. Several were transferred to theatres in central London.

When Gerry Raffles died in 1974, Miss Littlewood gave up most of her theatre work. He had in many ways been her wife, taking on the domestic tasks she had no time for. For much of the rest of her life she lived in France, near Vienne, where he is buried. Joan Littlewood shook up British theatre, but only briefly. Seeing a play remains mostly a middle-class pleasure. “Private Lives” was recently revived with great success.

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Overview

Sep 26th 2002
From The Economist print edition

Global **stockmarkets** fell again as fears of a war against Iraq, gloomy prospects for the global economy and shrinking corporate profits took their toll. America's Dow Jones Industrial Average fell to a four-year low. The Nasdaq fell to a six-year low. Britain's FTSE 100 fell by 2.4%, also to a six-year low. The yield on America's 10-year Treasury bond fell to 3.63%, the lowest level in 44 years, as investors sought shelter in bonds.

America's Federal Reserve kept interest rates unchanged, yet two members of its 12-member rate-setting board took the rare step of voicing their dissent in favour of lower rates.

American consumers remain anxious. The Conference Board's index of consumer confidence fell for the fourth month in a row, from 94.5 in August to 93.3 in September, its lowest reading in ten months. The index's measure of current conditions fell to its lowest level in eight years, although the future expectations index made its first upturn since May. America's buoyant housing market may be cooling: sales of existing homes fell by 1.7% in August.

Germany's Ifo business-confidence index fell for the fourth consecutive month in September, dropping to 88.2 from 88.8 in August, although the reading was better than some analysts had feared. Business confidence in **Italy** improved in September, and industrial output rose by 0.9% in the 12 months to July. Consumer prices in **Germany** rose by 1.1% in the year to September. **Austria's** GDP grew by 0.4% in the year to the second quarter. However, a broader indicator was more gloomy: in the year to July, industrial production in the **euro area** fell by 0.5%.

Britain's government borrowed £2.3 billion ($3.5 billion)in August, as previously announced spending increases took effect. Public-sector debt stood at 30% of GDP at the end of the month.

Unemployment in **Sweden** fell to 4.1% in August, down from 4.3% a year ago. **Denmark's** broad money growth slowed to 7.0% in the year to August.

Canadian consumer-price inflation in the 12 months to August rose to 2.6%, the highest rate since September 2001, and up from 2.1% in the 12 months to July.

The price of **gold** rose to $327 an ounce. The price has now risen by 18% this year.

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Output, demand and jobs

Sep 26th 2002
From The Economist print edition

% change on year ago

	GDP 1 qtr*	GDP 1 year	The Economist poll GDP forecasts 2002	2003	Industrial production latest	Retail sales (volume) latest	Unemployment % rate latest	year ago
Australia	+ 2.4	+ 3.8 Q2	+ 4.0	+ 3.7	+ 4.3 Q1	+ 6.3 Q2	6.2 Aug	6.8
Austria	na	+ 0.4 Q2	+ 0.9	+ 2.4	+ 2.5 Jun	– 0.2 May	4.2 Jul	3.6
Belgium	+ 0.8	+ 0.3 Q2	+ 1.1	+ 2.7	+ 3.8 Jul	– 4.2 Jun	12.0 Aug†	11.6
Britain	+ 2.4	+ 1.2 Q2	+ 1.7	+ 2.9	– 2.5 Jul	+ 5.0 Aug	5.2 Jul‡	5.1
Canada	+ 4.3	+ 3.2 Q2	+ 3.3	+ 3.4	+ 1.3 Jun	+ 6.3 Jun	7.5 Aug	7.3
Denmark	+ 4.4	+ 2.2 Q2	+ 1.6	+ 2.3	– 1.6 Jul	+ 4.1 Jun	5.1 Aug	5.1
France	+ 2.0	+ 1.0 Q2	+ 1.3	+ 2.6	– 1.7 Jul	+ 3.5 Aug	9.0 Jul††	8.7
Germany	+ 1.1	+ 0.1 Q2	+ 0.6	+ 2.2	– 1.9 Jul	– 1.7 Jul	9.9 Aug§	9.3
Italy	+ 0.9	+ 0.2 Q2	+ 0.8	+ 2.4	+ 0.9 Jul	nil Jul	9.0 Apr	9.5
Japan	+ 2.6	– 0.7 Q2	– 0.5	+ 1.0	+ 3.3 Jul	– 4.8 Jul	5.4 Jul	5.0
Netherlands	+ 0.5	+ 0.1 Q2	+ 0.9	+ 2.4	– 3.0 Jun	+ 3.2 Jul	2.3 Aug**	2.0
Spain	+ 1.8	+ 2.0 Q2	+ 2.0	+ 2.9	+ 1.8 Jul	na	11.3 Jul	10.6
Sweden	+ 2.4	+ 2.1 Q2	+ 1.8	+ 2.7	– 1.3 Jun	+ 4.7 Jul	4.1 Aug†	4.3
Switzerland	+ 0.4	– 0.4 Q2	+ 0.9	+ 2.2	– 8.8 Q1	+ 1.7 Jul	2.7 Aug†	1.7
United States	+ 1.1	+ 2.1 Q2	+ 2.5	+ 3.0	+ 0.4 Aug	+ 6.3 Jul	5.7 Aug	4.9
Euro area	+ 1.4	+ 0.6 Q2	+ 1.0	+ 2.4	– 0.5 Jul	– 0.9 Jun	8.3 Jul	8.0
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	+ 8.8	+ 2.5 Q2	na	na	+ 5.1 Jul	+ 3.8 Jun	8.1 Aug†	7.8
Greece	na	+ 4.0 Q2	na	na	+ 1.9 Jul	+ 9.9 Apr	na	na
Iceland	na	+ 3.12001	na	na	+ 3.3 2001	na	2.2 Aug†	1.1
Ireland	na	+ 2.9 Q1	na	na	+10.7 Jul	+ 1.4 Jul	4.4 Aug	3.7
Luxembourg	na	+ 3.52001	na	na	+ 4.3 May	– 9.1 Apr	2.8 Jul†	2.4
New Zealand	+ 4.3	+ 4.0 Q1	na	na	+ 4.3 Q1	+ 8.3 Q2	5.1 Q2	5.3
Norway	+ 3.1	+ 1.7 Q2	na	na	+ 4.5 Jul	+ 1.7 Aug	3.8 Q2	3.6
Portugal	+ 1.4	+ 1.4 Q1	na	na	– 2.0 Jul	+ 0.9 Jul	4.5 Q2†	3.9

*% change at an annual rate. †Not seasonally adjusted. ‡May-July; claimant count rate 3.1% in Aug. §EU harmonised rate 8.3% in Aug. **Jun-Aug. ††Revised series.

Text refers only to the first 16 countries listed

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Prices and wages

Sep 26th 2002
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2002	2003	latest		year ago	latest		year ago
Australia	+ 2.8	Q2	+ 6.0	+ 2.8	+ 2.5	– 1.1	Q2	+ 5.6	+ 3.7	Q2	+ 4.4
Austria	+ 1.9	Aug	+ 2.5	+ 1.7	+ 1.7	– 0.6	Aug	+ 1.7	+ 2.3	Aug	+ 2.9
Belgium	+ 1.3	Aug	+ 2.7	+ 1.7	+ 1.5	+ 0.8	Aug	– 1.0	+ 2.6	Q2	+ 2.6
Britain	+ 1.4	Aug	+ 2.1	+ 1.9	+ 2.4	+ 0.3	Aug	+ 0.2	+ 4.0	Jul	+ 4.6
Canada	+ 2.6	Aug	+ 2.8	+ 1.8	+ 2.2	– 0.3	Jul	+ 0.8	+ 3.0	Jun	+ 1.5
Denmark	+ 2.3	Aug	+ 2.5	+ 2.3	+ 2.0	– 0.3	Aug	+ 1.5	+ 3.7	Q2	+ 4.7
France	+ 1.8	Aug	+ 1.9	+ 1.8	+ 1.4	– 1.5	Jun	+ 2.3	+ 3.8	Q2	+ 4.2
Germany	+ 1.1	Sep	+ 2.1	+ 1.4	+ 1.2	– 0.5	Aug	+ 1.5	+ 2.1	Jul	+ 1.7
Italy	+ 2.4	Aug	+ 2.8	+ 2.3	+ 1.8	+ 0.1	Jul	+ 1.3	+ 2.2	Jul	+ 2.5
Japan	– 0.8	Jul	– 0.8	– 0.9	– 0.5	– 1.3	Aug	nil	– 5.6	Jul	+ 0.7
Netherlands	+ 3.3	Aug	+ 4.7	+ 3.6	+ 2.4	– 0.4	Jul	+ 2.4	+ 3.0	Jul	+ 5.1
Spain	+ 3.6	Aug	+ 3.7	+ 3.3	+ 2.6	+ 0.5	Aug	+ 1.6	+ 4.0	Q1	+ 3.4
Sweden	+ 2.0	Aug	+ 3.1	+ 2.3	+ 2.0	– 0.8	Jul	+ 2.1	+ 2.9	Jun	+ 2.8
Switzerland	+ 0.5	Aug	+ 1.1	+ 1.0	+ 1.2	– 1.4	Aug	– 0.2	+ 2.5	2001	+ 1.3
United States	+ 1.8	Aug	+ 2.7	+ 1.6	+ 2.2	– 1.6	Aug	+ 2.0	+ 3.1	Aug	+ 4.1
Euro area	+ 2.1	Aug	+ 2.7	+ 2.1	+ 1.6	– 0.6	Jul	+ 2.1	+ 3.3	Q1	+ 2.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.4	Aug	+ 2.6	na	na	– 1.8	Aug	– 0.1	+ 3.8	Q2	+ 4.9
Greece	+ 3.5	Aug	+ 3.8	na	na	+ 0.7	Jul	+ 4.5	na		na
Iceland	+ 3.1	Sep	+ 8.4	na	na	+ 6.1	Sep	+ 6.8	+ 6.0	Aug	+ 8.8
Ireland	+ 4.5	Aug	+ 4.6	na	na	– 0.8	Aug	+ 1.0	+ 8.9	Q1	+ 7.4
Luxembourg	+ 1.8	Aug	+ 2.8	na	na	– 1.0	Jul	+ 0.6	+ 0.9	May	+ 2.7
New Zealand	+ 2.8	Q2	+ 3.2	na	na	+ 1.5	Q2	+ 8.1	+ 2.1	Q2	+ 1.8
Norway	+ 1.4	Aug	+ 2.7	na	na	– 8.6	Aug	– 4.3	+ 4.9	Q2	+ 4.4
Portugal	+ 3.7	Aug	+ 4.0	na	na	– 1.8	Aug	– 0.2	– 0.2	Jun	– 0.6

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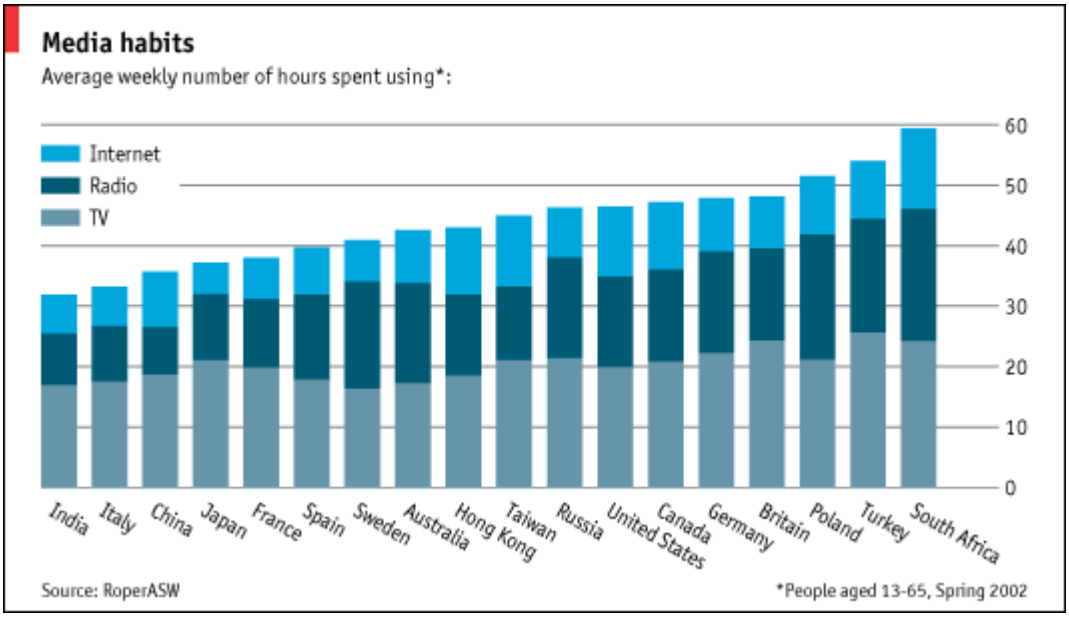
Media habits

Sep 26th 2002
From The Economist print edition



According to a study by RoperASW, a consultancy, South Africans say they devote more than eight hours a day to radio, television and recreational use of the Internet. With more than 13 hours a week spent online, they are keener web-surfers than the Americans, Canadians or Taiwanese. Among rich countries, Britain has the most dedicated television watchers, who spend more than 24 hours a week in front of the box.

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Money and interest rates

Sep 26th 2002
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (Sep 25th 2002)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	– 4.1	+ 9.4	Jul	4.94	4.43	4.80	5.26	5.60	6.28
Britain	+ 8.6	+ 5.8	Aug	3.91	4.44	3.54	4.41	4.87	5.74
Canada	+16.2	+ 7.3	Aug	2.83	3.06	3.32	4.92	5.32	6.74
Denmark	+ 6.3	+ 7.0	Aug	3.40	4.24	3.58	4.50	5.01	6.86
Japan	+31.5	+ 3.5	Aug	0.01	0.01	0.00	1.17	1.39	1.33
Sweden	+ 2.2	+ 4.2	Jun	4.15	3.71	4.26	4.83	5.27	4.82
Switzerland	+12.0	+ 5.8	Aug	0.75	2.25	0.75	2.54	3.22	3.80
United States	+ 3.2	+ 8.3	Aug	1.75	2.45	1.96	3.75	4.64	6.25‡
Euro area†	+ 7.6	+ 7.1	Jul	3.29	3.65	3.17	4.25	4.75	5.22

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡Sep 18th. Benchmarks: US 30-year 4.72%, Japan No.242 1.21%. Central bank rates: US fed funds 1.75%, ECB refinancing 3.25%, BOJ overnight call 0.002%, BOE repo 4.00%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS Warburg, DRI-WEFA, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Sep 26th 2002
From The Economist print edition

1995=100

	Sep 17th	Sep 24th*	% change on one month	% change on one year
Dollar index				
All items	75.5	74.6	+ 1.9	+14.9
Food	81.5	80.4	+ 4.3	+19.7
Industrials				
All	67.5	66.8	– 1.7	+ 7.7
Nfa†	69.5	69.6	+ 2.4	+15.5
Metals	65.9	64.5	– 1.6	+ 1.4
Sterling index				
All items	77.6	75.6	+ 0.2	+ 8.4
Euro index				
All items	102.5	100.1	+ 1.8	+ 8.1
Yen index				
All items	98.5	98.0	+ 6.4	+20.7
Gold				
$ per oz	316.60	326.80	+ 5.1	+12.9
West Texas Intermediate				
$ per barrel	29.11	30.84	+ 7.0	+41.3

* Provisional. † Non-food agriculturals.

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Stockmarkets

Sep 26th 2002
From The Economist print edition

Market indices

	Sep 25th	2002 high	2002 low	% change on one week	% change on record high	% change on Dec 31st 2001 in local currency	% change on Dec 31st 2001 in $ terms
Australia (All Ordinaries)	2,946.6	3,440.0	2,937.8	– 4.0	–14.3	–12.3	– 6.8
Austria (ATX)	1,062.2	1,357.2	1,049.2	– 2.6	–38.9	– 6.9	+ 2.4
Belgium (Bel 20)	1,888.9	2,899.8	1,837.5	– 6.3	–48.7	–32.1	–25.3
Britain (FTSE 100)	3,696.2	5,323.8	3,671.1	– 4.4	–46.7	–29.2	–24.0
Canada (Toronto Composite)	6,165.0	7,958.1	6,068.9	– 2.2	–45.9	–19.8	–19.1
Denmark (KBX)	162.7	233.4	162.7	– 5.7	–46.1	–27.6	–20.3
France (SBF 250)	1,887.3	3,081.9	1,867.0	– 7.4	–57.0	–36.7	–30.4
(CAC 40)	2,785.4	4,688.0	2,742.8	– 7.2	–59.8	–39.8	–33.8
Germany (Xetra DAX)	2,962.5	5,462.6	2,873.2	– 5.2	–63.3	–42.6	–36.9
Italy (BCI)	1,026.4	1,513.0	1,004.3	– 6.8	–53.0	–28.4	–21.3
Japan (Nikkei 225)	9,165.4	11,979.9	9,075.1	– 3.2	–76.4	–13.1	– 7.2
(Topix)	900.9	1,139.4	886.4	– 2.9	–68.8	–12.7	– 6.8
Netherlands (AEX)	300.0	531.2	293.8	– 5.1	–57.2	–40.8	–34.9
Spain (Madrid SE)	577.5	848.1	573.1	– 7.3	–49.6	–29.9	–23.0
Sweden (Affarsvarlden Gen)	133.7	236.8	131.5	– 5.8	–66.6	–42.2	–35.0
Switzerland (Swiss Market)	4,644.6	6,694.1	4,561.4	– 3.5	–44.8	–27.6	–19.7
United States (DJIA)	7,841.8	10,635.3	7,683.1	– 4.0	–33.1	–21.8	–21.8
(S&P 500)	839.7	1,172.5	797.7	– 3.4	–45.0	–26.9	–26.9
(Nasdaq Comp)	1,222.3	2,059.4	1,182.3	– 2.4	–75.8	–37.3	–37.3
Europe (FTSE Eurotop 300)*	821.1	1,279.7	808.6	– 4.9	–51.8	–34.9	–28.4
Euro area (FTSE Ebloc 100)*	670.6	1,125.1	657.1	– 6.1	–56.7	–39.7	–33.7
World (MSCI)†	747.1	1,024.4	734.8	– 3.9	–48.4	na	–25.6
World bond market (Salomon)‡	496.5	504.2	430.3	+ 0.0	– 1.5	na	+12.9

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms.
‡Salomon Smith Barney World Government Bond Index, total return, in $ terms.

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About sponsorship

Trade, exchange rates and budgets

Sep 26th 2002
From The Economist print edition

	Trade balance*, $bn latest 12 months	Current account $bn latest 12 mths	Current account The Economist poll % of GDP, forecast 2002	Current account The Economist poll % of GDP, forecast 2003	Exchange rate trade-weighted† Sep 25th	Exchange rate trade-weighted† year ago	Currency units per $ Sep 25th	Currency units per $ year ago	Currency units per £	Currency units per euro	Currency units per ¥100	Budget balance % of GDP 2002‡
Australia	− 1.3 Jul	− 11.6 Q2	− 3.7	− 3.8	73.2	67.3	1.84	2.04	2.87	1.80	1.50	0.1
Austria	− 1.4 Jun	− 0.9 Jul	− 2.2	− 1.9	na	100.4	1.02	1.09	1.59	–	0.83	-0.3
Belgium	+ 14.7 Jul	+ 11.8 Mar§	+ 5.0	+ 5.1	na	99.3	1.02	1.09	1.59	–	0.83	nil
Britain	− 44.9 Jul	− 31.2 Q1	− 2.1	− 1.9	107.1	106.1	0.64	0.68	–	0.63	0.52	-0.8
Canada	+ 34.3 Jul	+ 12.1 Q2	+ 2.1	+ 2.2	75.2	76.1	1.58	1.57	2.47	1.55	1.29	1.0
Denmark	+ 7.1 Jul	+ 3.3 Jul	+ 1.9	+ 1.8	102.9	103.4	7.59	8.07	11.8	7.43	6.18	2.2
France	+ 10.2 Jul	+ 27.3 Jul	+ 1.7	+ 1.6	na	102.0	1.02	1.09	1.59	–	0.83	-2.0
Germany	+104.5 Jul	+ 30.2 Jul	+ 1.2	+ 1.0	na	99.0	1.02	1.09	1.59	–	0.83	-2.8
Italy	+ 9.8 Jun	− 3.2 Jun	− 0.1	nil	na	72.8	1.02	1.09	1.59	–	0.83	-1.4
Japan	+ 83.8 Jul	+110.9 Jul	+ 2.9	+ 2.9	132.0	141.6	123	118	192	120	–	-8.0
Netherlands	+ 25.0 Jul	+ 2.7 Q2	+ 3.9	+ 4.0	na	98.3	1.02	1.09	1.59	–	0.83	0.1
Spain	− 36.4 Jun	− 15.3 Jun	− 2.1	− 1.8	na	74.4	1.02	1.09	1.59	–	0.83	-0.3
Sweden	+ 14.6 Aug	+ 8.1 Jul	+ 3.2	+ 3.2	77.4	70.8	9.33	10.8	14.6	9.14	7.60	2.1
Switzerland	+ 3.5 Aug	+ 22.7 Q2	+10.0	+10.2	114.4	112.1	1.50	1.60	2.33	1.46	1.22	na
United States	−438.5 Jul	−428.8 Q2	− 4.5	− 4.1	114.8	116.6	–	–	1.56	0.98	0.81	-1.0
Euro area	+ 83.3 Jul	+ 27.5 Jul	+ 0.5	+ 0.5	81.6	79.7	1.02	1.09	1.59	–	0.83	-1.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 12.7 Jul	+ 8.7 Jul	na	na	na	79.3	1.02	1.09	1.59	–	0.83	3.2
Greece	− 18.8 Mar	− 7.6 Jun	na	na	na	57.6	1.02	1.09	1.59	–	0.83	0.4
Iceland	+ 0.1 Jul	− 0.1 Q2	na	na	na	na	88.3	101.2	138	86.5	71.9	-0.5
Ireland	+ 33.5 Jun	− 0.4 Q1	na	na	na	87.9	1.02	1.09	1.59	–	0.83	0.1
Luxembourg	− 2.7 Jun	+ 1.7 Q1	na	na	na	99.3	1.02	1.09	1.59	–	0.83	2.2
New Zealand	− 0.1 Aug	− 1.2 Q1	na	na	86.4	76.4	2.13	2.47	3.33	2.09	1.73	0.1
Norway	+ 24.5 Aug	+ 25.5 Jul	na	na	105.8	96.5	7.51	8.75	11.7	7.35	6.12	14.0
Portugal	− 12.6 Jun	− 9.5 Jun	na	na	na	89.7	1.02	1.09	1.59	–	0.83	-2.4

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †1990=100, Bank of England. ‡OECD forecast. §New series.

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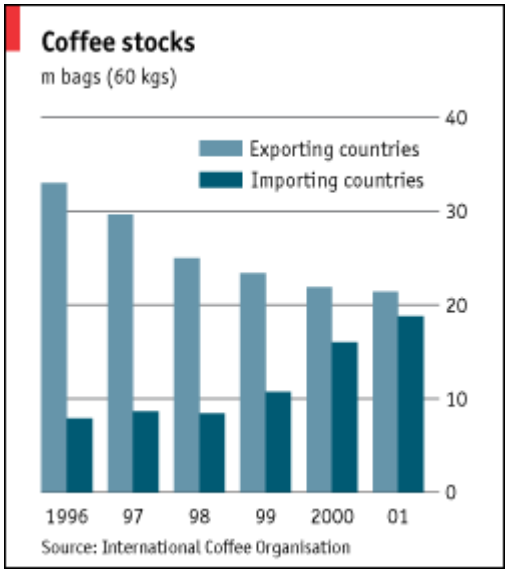
Coffee stocks

Sep 26th 2002
From The Economist print edition

As coffee-exporting countries have reduced their stocks in recent years, consuming countries have increased theirs. The net result? Global stocks of coffee have hardly changed.



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Overview

Sep 26th 2002
From The Economist print edition

Jitters over the outcome of **Brazil's** presidential election sent the *real* to a record low of 3.78 against the dollar, a fall of almost 40% since the beginning of the year.

Argentina's economic collapse may be bottoming out. In the second quarter, GDP grew by 0.9%. However, economic output was 13.6% lower than a year ago.

Poland's industrial output fell by 1.1% in the year to August, after rising by 5.7% in the year to July.

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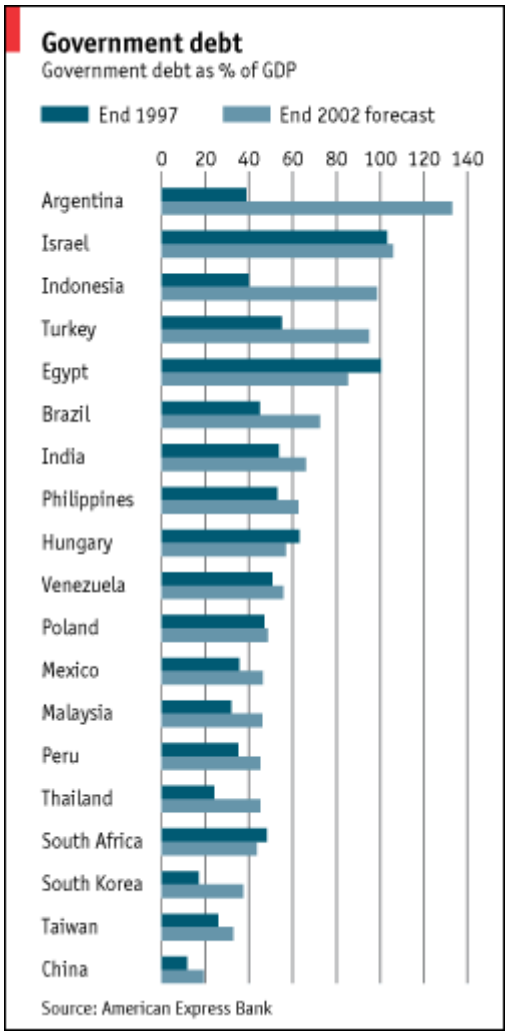
Government debt

Sep 26th 2002
From The Economist print edition

In most emerging markets governments have taken on more debt over the past five years. As a percentage of GDP, the public debt of Argentina has more than tripled to 133%. By the same measure, the debts of South Korea and Indonesia have both more than doubled.

Are these debts sustainable? The size of the debt to GDP ratio is not the only thing that matters: the pace of GDP growth and real interest rates also determine the burden of debt. By these criteria, the public debts of Indonesia, the Philippines, Mexico, South Africa and South Korea are on a sustainable course. High interest rates faced by Brazil and Turkey, however, suggest that their debts can only get worse.



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Economy

Sep 26th 2002
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 8.0	Q2	+12.7	Aug	– 0.7	Aug	+29.1	Aug	+17.4	2001	246.8	Jun
Hong Kong	+ 0.5	Q2	–11.6	Q1	– 3.3	Aug	– 8.2	Jul	+15.7	Q2	112.3	Aug
India	+ 6.4	Q1	+ 6.4	Jul	+ 3.9	Jul	– 5.1	Jul	+ 1.4	Q1	58.3	Aug
Indonesia	+ 3.5	Q2	– 9.4	Q4	+10.6	Aug	+27.3	Jul	+ 6.1	Q1	29.5	Jul
Malaysia	+ 3.8	Q2	+ 6.9	Jul	+ 2.1	Aug	+13.4	Jul	+ 7.0	Q1	32.8	Jul
Philippines	+ 4.5	Q2	+ 6.4	Jul	+ 2.9	Aug	+ 2.8	Jul	+ 6.3	Jun	13.4	Aug
Singapore	+ 3.9	Q2	+15.8	Aug	– 0.4	Aug	+ 6.9	Aug	+17.5	Q2	80.9	Aug
South Korea	+ 6.3	Q2	+ 8.9	Jul	+ 2.4	Aug	+ 9.8	Aug	+ 5.3	Jul	116.5	Aug
Taiwan	+ 3.0	Q2	+ 5.8	Aug	– 0.3	Aug	+18.6	Aug	+24.8	Q2	156.4	Aug
Thailand	+ 5.1	Q2	+ 9.6	Jul	+ 0.3	Aug	+ 3.8	Jul	+ 6.5	Jul	37.0	Jul
Argentina	–13.6	Q2	– 9.2	Aug	+36.5	Aug	+13.4	Jul	nil	Q1	9.0	Jul
Brazil	+ 1.0	Q2	+ 3.3	Jul	+ 7.5	Aug	+ 7.4	Aug	–16.7	Jul	39.1	Jul
Chile	+ 1.7	Q2	+ 8.6	Jul	+ 2.2	Aug	+ 2.4	Aug	– 0.6	Q2	15.0	Jul
Colombia	+ 2.2	Q2	– 1.2	Jun	+ 6.0	Aug	+ 0.5	Jun	– 1.4	Q1	10.6	Jul
Mexico	+ 2.1	Q2	+ 1.9	Jul	+ 5.3	Aug	– 9.0	Aug	–16.3	Q2	46.1	Jul
Peru	+ 3.8	Jul	+ 6.8	Jul	+ 0.1	Aug	+ 0.2	Jul	– 1.0	Q2	9.2	Jul
Venezuela	– 9.9	Q2	–17.1	Jun	+24.0	Aug	+ 8.5	Q2	+ 1.9	Q2	7.6	Jun
Egypt	+ 4.9	2001†	+ 7.8	2001†	+ 2.7	Jun	– 7.9	Jun	– 0.1	Q1	12.6	May
Israel	– 1.7	Q2	– 1.8	Jul	+ 6.2	Aug	– 6.1	Aug	– 2.3	Q1	24.5	Aug
South Africa	+ 2.2	Q2	+ 7.8	Jul	+11.6	Aug	+ 3.1	Jul	– 0.3	Q2	6.0	Jul
Turkey	+ 2.3	Q1	+12.3	Jul	+40.2	Aug	–10.3	Jun	+ 2.0	Jun	23.2	Jul
Czech Republic	+ 2.5	Q2	+10.8	Jul	+ 0.6	Aug	– 2.3	Aug	– 2.3	Q2	21.6	Aug
Hungary	+ 3.1	Q2	+ 5.1	Jul	+ 4.5	Aug	– 2.5	Jul	– 2.1	Jul	10.3	Jul
Poland	+ 0.8	Q2	– 1.1	Aug	+ 1.2	Aug	–10.4	Jul	– 6.4	Jul	28.3	Aug
Russia	+ 4.1	Q2	+ 3.4	Aug	+15.2	Aug	+42.4	Jul	+28.3	Q2	40.6	Aug
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Pakistan	+ 3.3	2001†	+21.3	Apr	+ 3.7	Aug	– 1.1	Aug	+ 0.3	2001†	4.8	Jun
Saudi Arabia	+ 1.2	2001	na		– 0.2	Apr	+44.1	2001	+14.5	2001	18.1	Jul

*Excluding gold, except Singapore; IMF definition. †Year ending June.

Text refers only to the first 25 countries listed

Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends*.

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Financial markets

Sep 26th 2002
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Sep 25th		Dec 31st 2001	
	Sep 25th	year ago	Sep 25th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	12.9	na	1,667.4	+0.2	– 2.6	– 2.6
Hong Kong	7.80	7.80	12.2	1.89	9,124.9	– 3.7	– 19.9	– 20.0
India	48.4	47.9	75.5	5.76	3,021.1	– 1.6	– 7.4	– 7.7
Indonesia	9,000	9,635	14,050	14.27	408.6	– 2.5	+ 4.2	+ 20.5
Malaysia	3.80	3.80	5.93	3.20	636.8	– 6.0	– 8.5	– 8.5
Philippines	52.4	51.4	81.8	6.25	1,126.6	– 2.3	– 3.6	– 5.0
Singapore	1.78	1.77	2.78	1.31	1,342.6	– 6.2	– 17.3	– 14.4
South Korea	1,230	1,300	1,920	4.82	658.0	– 6.5	– 5.2	+ 1.3
Taiwan	34.9	34.6	54.4	2.10	4,186.0	– 6.6	– 24.6	– 24.3
Thailand	43.4	44.3	67.8	2.00	336.0	– 5.1	+ 10.6	+ 12.6
Argentina	3.66	1.00	5.71	32.20	380.1	+0.6	+ 28.7	– 64.8
Brazil	3.75	2.73	5.85	17.90	9,236.0	– 2.8	– 32.0	– 58.0
Chile	745	695	1,164	2.64	4,731.7	– 2.3	– 12.3	– 22.2
Colombia	2,796	2,329	4,365	7.96	1,237.7	+2.9	+ 15.6	– 5.9
Mexico	10.27	9.53	16.0	8.60	5,808.4	– 2.5	– 8.8	– 18.6
Peru	3.64	3.48	5.68	16.13	1,149.7	– 1.1	– 2.2	– 7.4
Venezuela	1,463	743	2,283	29.10	7,367.2	– 0.3	+ 12.1	– 41.9
Egypt	4.63	4.25	7.23	7.11	5,275.2	– 0.3	+ 0.1	– 1.2
Israel	4.88	4.36	7.61	6.40	339.5	– 4.3	– 24.0	– 31.2
South Africa	10.6	8.87	16.5	12.55	9,418.2	– 1.7	– 9.8	+ 2.2
Turkey	1,650,000	1,552,000	2,575,815	42.00	9,119.2	– 1.5	– 33.8	– 41.7
Czech Republic	31.1	36.9	48.5	2.89	447.9	+0.6	+ 13.5	+ 29.8
Hungary	249	279	389	9.69	7,320.1	– 1.6	+ 2.6	+ 13.3
Poland	4.15	4.20	6.47	8.02	13,065.3	+0.0	– 6.2	– 10.5
Russia	31.7	29.4	49.4	21.00	343.1‡	+4.0	+ 36.9	+ 31.9
EMF (MSCI)*	1.00	1.00	1.56	na	269.7	– 5.2	na	– 15.0
EMBI+†	1.00	1.00	1.56	na	202.6	– 0.9	na	+ 1.1

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡ In $ terms.

Sources: National statistics offices, central banks and stock exchanges; Thomson Financial Datastream; Economist Intelligence Unit; Reuters; Warburg Dillon Read; J.P Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Garanti Bank; Deutsche Bank; *Russian Economic Trends*.

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